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2004

# AICPA audit committee toolkit

American Institute of Certified Public Accountants. Audit Committee Effectiveness Center

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The AICPA  
**Audit  
Committee  
TOOLKIT**

Presented by the AICPA's  
Audit Committee Effectiveness Center  
in cooperation with CNA and  
the AICPA Foundation



## NOTICE TO READERS

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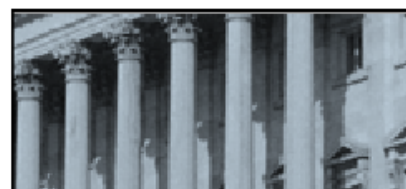
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1 2 3 4 5 6 7 8 9 0 *NF* 0 9 8 7 6 5 4

ISBN 0-87051-503-9



December 2003

As a profession, CPAs are committed to protecting the public interest, whether those CPAs are employed in corporate America, or as the auditors of public companies or nonpublic organizations. With the foundation of the profession firmly in the audit arena, who better than CPAs to work on and with the audit committees of boards of directors? It is with that in mind that the AICPA introduces the Audit Committee Effectiveness Center (ACEC) and the two main features of the ACEC: *The AICPA Audit Committee Toolkit* and the *Audit Committee Matching System*.

*The AICPA Audit Committee Toolkit* brings you checklists, matrices, questionnaires, and other materials that are designed to help the audit committee do the job they need to do.

*The Audit Committee Matching System* is a means to link CPAs who are willing to be on corporate boards and audit committees with the organizations that need the CPA skill-set in those roles.

The ACEC is available only through the AICPA Web site at [www.aicpa.org](http://www.aicpa.org). New tools will be created, and these tools will be updated and available through the Web site. The tools will be downloadable in MS Word, which will allow you (actually, we *encourage* you) to download and tailor or customize the tools to your company. The features of ACEC are intended for all companies: public, private, not-for-profit, and other public interest entities.

Another feature of the ACEC will be an *E-Alert* option. By registering for the e-mail alerts, you will be kept informed of new tools as they are released, updates to existing tools, and news items relating to audit committees that could develop from current events.

We are grateful to the sponsors of the ACEC, such as CNA and the AICPA Foundation; it is through their support and consultation that we are able to bring the Toolkit to you, both in hard copy and continuing through the ACEC Web site on [www.aicpa.org](http://www.aicpa.org).

If you have questions on how to use these tools, ideas for new tools, or other feedback, please send to our staff colleagues at [acec@aicpa.org](mailto:acec@aicpa.org).

Sincerely,

Barry C. Melancon, CPA  
President and CEO

John F. Morrow, CPA  
Vice President  
The New Finance





## **Acknowledgments**

We want thank several of our members who participated in creating this Toolkit. First of all, Olivia Kirtley, a past chair of the AICPA Board of Directors, and currently the chair of the audit committees of three public companies, Olivia is an invaluable resource to us from her experience as a CFO and a director/audit committee member. Second is Bob Brewer, currently the vice president of internal audit at Office Depot, Inc., and a past chair of our Business & Industry Executive Committee. Bob has been a huge help in reviewing these tools and providing his insight and guidance in their development.

Finally, to our staff colleagues, Alan Anderson, Chuck Landes, Olivia Lane, Michael Doyle, Kim Mangal, Steve Geske, Mary Mooney, and Cheryl Erenberg, who worked to make the publication of this Toolkit timely. We are grateful to these members and staff for their help, and their willingness to make this book and the accompanying Web site available in support of the public interest.



# The Audit Committee Toolkit—Table of Contents

<u>Tool</u>	<u>Page</u>
Audit Committee Charter Matrix .....	1
Audit Committee Financial Expert Decision Tree .....	15
Conducting an Audit Committee Executive Session: Guidelines and Questions .....	17
Engaging Independent Counsel and Other Advisors .....	39
Guidelines for Hiring the Chief Audit Executive (CAE) .....	41
Sample Request for Proposal Letter for CPA Services (Public Company) .....	45
Sample Request for Proposal Letter for CPA Services (Nonpublic Organization) .....	49
Peer Review of CPA Firms: An Overview .....	53
Internal Control: A Tool for the Audit Committee .....	57
Fraud and the Responsibilities of the Audit Committee: An Overview .....	71
Management's Summary of Off-Balance-Sheet Transactions .....	75
Issues Report From Management .....	81
Discussions to Expect From the Independent Auditor .....	85
Tracking Report: Anonymous Submission of Suspected Wrongdoing (Whistleblowers) .....	91
Evaluating the Internal Audit Team: Guidelines and Questions .....	93
Evaluating the Independent Auditors: Questions to Consider .....	99
Conducting an Audit Committee Self-Evaluation: Guidelines and Questions .....	105
Common Security and Exchange Commission Filings: An Overview .....	109
SEC Final Rule on Audit Committee Financial Experts .....	119
Resources for Audit Committees .....	133





## Audit Committee Charter Matrix

**INSTRUCTIONS FOR USING THIS TOOL:** Preparing an Audit Committee charter is often referred to as a best practice, and is actually required for many public companies. However, the charter is often prepared and forgotten except for its annual review. This tool is designed to help audit committees make the charter a living document, and use it to manage the agenda. This tool is meant as a sample. Users of the tool should put their own charter in the first column, and use this example as a guide for defining the steps to accomplish each objective, the associated performance measure, and the scheduling. The Audit Committee charter presented here (first column) is based on one from a real company, and in some places goes beyond the requirements of the Sarbanes-Oxley Act of 2002 (the Act) and stock exchange requirements. This is by the choice of the company in question, and may be considered a good practice.

## Audit Committee Charter Matrix

For the Year Ending: \_\_\_\_\_

Audit Committee Charter	Steps to Accomplish the Objective	Deliverable	When to Achieve (Frequency Due Date)	Date Completed
1. Each member of the Audit Committee shall be a member of the board of directors, in good standing, and shall be independent in order to serve on this committee.	Test for independence, based on the regulations under the Act and any other regulations that may be operative.	Indicate in the Audit Committee minutes whenever a new member is appointed; acknowledge that independence has been verified.	Affirm annually or whenever a change in status by any Audit Committee member occurs.	
2. At least one member of the Audit Committee shall be designated as a <i>financial expert</i> . (See the tool “ <a href="#">Audit Committee Financial Expert Decision Tree</a> ” in this toolkit.)	Ascertain that at least one member of the audit committee meets the requirements of a financial expert under the regulations of the Act.	Indicate in Audit Committee meeting minutes which member of the audit committee is designated as the financial expert.	Affirm annually, unless there is a change in status.	
3. Review the Committee’s charter annually, reassess the adequacy of this charter, and recommend any proposed changes to the board of directors. Consider changes that are necessary as a result of new laws or regulations.	Review the charter each year. Assess the appropriateness of each point in the charter in light of the previous year’s experience. Assess the completeness of the charter in light of new best practices and new legal or regulatory requirements.	Report to the board on the appropriateness of the Audit Committee charter and any revisions recommended	Review annually, unless changes are needed during the course of the year.	

When to

Audit Committee Charter	Steps to Accomplish the Objective	Deliverable	Achieve (Frequency Due Date)	Date Completed
<p>4. The Audit Committee shall meet at least four times per year, and each time the company proposes to issue a press release with its quarterly or annual earnings information. These meetings may be combined with regularly scheduled meetings), or more frequently as circumstances may require. The Audit Committee may ask members of management or others to attend the meetings and provide pertinent information as necessary.</p>	<p>In-person meetings should be held at least once each quarter. All members are expected to attend each meeting in person, via telephone conference or videoconference.</p> <p>Telephone conference meetings may be held more frequently.</p> <p>The agendas for meetings should be prepared and provided to members in advance, along with appropriate briefing materials.</p>	<p>Prepare minutes that document decisions made and action steps following meetings and review for approval.</p> <p>Meeting minutes should be filed with the board of directors.</p>	<p>Minutes should be distributed as soon as possible but no later than prior to the next meeting.</p>	
<p>5. Conduct executive sessions with the outside auditors, CEO (chief executive officer), CFO (chief financial officer), chief audit executive (CAE), general counsel, outside counsel, director of financial reporting, controller, and anyone else as desired by the committee.</p>	<p>Establish these sessions in conjunction with quarterly meetings or as necessary. (See the tool “<a href="#">Conducting an Audit Committee Executive Session: Guidelines and Questions</a>,” in this toolkit.)</p>	<p>Develop action steps to be taken, if appropriate.</p>	<p>Review quarterly, and as necessary.</p>	
<p>6. The Audit Committee shall be authorized to hire outside counsel or other consultants as necessary. (This may take place any time during the year.)</p> <p>(See the tool “<a href="#">Engaging Independent Counsel and Other Advisers</a>,” in this toolkit.)</p>	<p>A budget should be established for this purpose. Requests for proposals (RFPs) should be used if time permits.</p>	<p>Report submitted by outside counsel or consultant.</p>	<p>Review as needed.</p>	

When to

Audit Committee Charter	Steps to Accomplish the Objective	Deliverable	Achieve (Frequency Due Date)		Date Completed
7. Review and concur in the appointment, replacement, reassignment, or dismissal of the CAE.  (See the tool “Guidelines for Hiring the Chief Audit Executive,” in this toolkit.)	Meet in executive session at each meeting with the CAE. Hold special meetings as may be necessary to address appointment, reassignment, or dismissal of CAE.  The audit committee chair should be available if any unforeseen issues arise between meetings relating to the CAE.  Meet at least once annually with other members of executive management and the external auditors to discuss the performance of CAE.  Discuss job satisfaction and other employment issues with the CAE.	Report to the full board on the performance of the CAE including the effectiveness of the internal audit function.	Conduct ongoing reviews, as changes can be made at any time during the year.		

Audit Committee Charter	Steps to Accomplish the Objective	Deliverable	Achieve (Frequency Due Date)	Date Completed
<p>8. Appoint the independent auditors to be engaged by the company, establish the audit fees of the independent auditors, pre-approve any non-audit services provided by the independent auditors, including tax services, before the services are rendered.</p> <p>Review and evaluate the performance of the independent auditors and review with the full board of directors any proposed discharge of the independent auditors.</p> <p>(See the tools: "Sample Request for Proposal Letter for CPA Services (Public Company)," "Sample Request for Proposal Letter for CPA Services (Nonpublic Organization)," and "Peer Review of CPA Firms: An Overview," in this toolkit.)</p>	<p>At least once each year, discuss each of these items with management, the CAE, and the board of directors.</p> <p>Review total audit fee in relation to any nonaudit services being provided by the independent auditor.</p> <p>Discuss the Audit Committee's review of the independent auditors with the board of directors.</p> <p>Ascertain that the independent auditors do not perform any nonaudit service that is prohibited by Section 201 of the Sarbanes-Oxley Act of 2002.</p>	<p>Report and recommend on the performance and fees paid to the independent auditors. Review the scope of all services provided by the independent audit firm throughout the organization.</p>	<p>Review soon after year-end, so that the recommendation for the appointment of the outside auditor can be included in the proxy statement.</p>	
<p>9. Ascertain that the lead (or concurring) audit partner from any public accounting firms performing audit services, serves in that capacity for no more than five fiscal years of the company. In addition, ascertain that any partner other than the lead or concurring partner serves no more than seven years at the partner level on the company's audit.</p>	<p>Establish when the five-year limit will be reached for the current lead partner. At least a year prior to that time, discuss transition plans for the new lead partner.</p>	<p>Document these discussions in Audit Committee meeting minutes</p>	<p>Review annually with the independent auditors.</p>	
When to				

Audit Committee Charter	Steps to Accomplish the Objective	Deliverable	Achieve (Frequency Due Date)	Date Completed
10. Review with management the policies and procedures with respect to officers' expense accounts and perquisites, including their use of corporate assets, and consider the results of any review of these areas by the internal auditor or the independent auditors.	Review policies and procedures annually. Discuss with chief audit executive the need for testing by either the internal auditors, independent auditors, or other parties.	Report issues, if any, to the board.	Review policies and procedures at the second quarterly meeting and discuss audit plan.  Review any significant findings as they arise.	
11. Consider, with management, the rationale for employing audit firms other than the principal independent auditors.	Establish a policy for the Audit Committee to pre-approve engaging auditors other than the principal independent auditors.  Use RFPs for engaging auditors or other professionals for nonaudit, or other services that the auditor cannot perform.  Review compliance with the policy by management.  (See the tools "Sample Request for Proposal Letter for CPA Services (Public Company)," and "Sample Request for Proposal Letter for CPA Services (Nonpublic Organization)" in this toolkit.)	Document auditor selection criteria. Also, use a decision matrix to evaluate and document external auditor selection.  Prepare an engagement letter for each engagement.	Continually review the policy and compliance with it.  Other auditors may need to be hired at any point during the year.	

When to

Audit Committee Charter		Steps to Accomplish the Objective	Deliverable	Achieve (Frequency Due Date)	Date Completed
12. Inquire of management, the CAE, and the independent auditors about significant risks or exposures facing the company; assess the steps management has taken or proposes to take to minimize such risks to the company; and periodically review compliance with such steps.		Create a portfolio that documents the material risks that the company faces. Update as events occur. Review with management and the CAE quarterly or sooner if necessary, to make sure it is up-to-date.	Submit a risk report including mitigation strategies and quantifiable risks and insurance to cover such risks, e.g., loss of business.	Review at least once each year, and more frequently if necessary.	
13. Review with the independent auditor, the controller of the company, and the CAE, the audit scope and plan of the internal auditors and the independent auditors. Address the coordination of audit efforts to assure the completeness of coverage, reduction of redundant efforts, and the effective use of audit resources.		Meet with independent audit partner, the controller and CAE to discuss scope of the previous year's audit, and lessons learned. Later, discuss planned scope for audit of current year.	Document the meeting in the Audit Committee meeting minutes.	At the second quarter meeting each year, review the scope of the previous year's audit, and the inter-relationship between the internal and external auditors with respect to the scope of the independent auditors' work.  At the third quarter meeting each year, review the plans for the audit of the current year.	
14. Review with management and the CAE: <ul style="list-style-type: none"><li>• Significant findings on internal audits during the year and management's responses thereto</li><li>• Any difficulties the internal audit team encountered in the course of their audits, including any restrictions on the scope of their work or access to required information</li><li>• Any changes required in the scope of their internal audit</li></ul>		Review reports of all internal audits from the preceding 12 months and planned for the upcoming six months along with the status of each planned audit.  Review and discuss the findings for each audit completed since the prior meeting, and management's response to the report.  Discuss internal audit department budget and staffing with CAE.	Report on the status of all internal audits planned for the next quarter and/or year.	Review at each meeting.	
				When to	

## The AICPA Audit Committee Toolkit

Audit Committee Charter	Steps to Accomplish the Objective	Deliverable	Achieve (Frequency Due Date)	Date Completed
<ul style="list-style-type: none"> <li>The internal auditing department budget and staffing</li> <li>The internal auditing department charter</li> <li>Internal auditing's compliance with the Institute of Internal Auditors' (IIA's) Standards for the Professional Practice of Internal Auditing (Standards)</li> </ul>	Discuss internal audit's compliance with IIA Standards, including the requirement for a peer review once every five years.			
15. Inquire of the CEO and CFO regarding the "quality of earnings" of the company from a subjective as well as an objective standpoint.	Discuss "quality of earnings" with the CEO, CFO, and other executives. Identify any issues addressed, and their resolution.	Include in agenda for executive sessions. (See the tool "Conducting an Audit Committee Executive Session: Guidelines and Questions," in this toolkit.)	Review, as necessary, but at least annually.	
16. Review with the independent accountants and the CAE: <ul style="list-style-type: none"> <li>The adequacy of the company's internal controls including computerized information system controls and security</li> </ul>	Review the reports of the internal audit team for all audits completed since the prior Audit Committee meeting. Review key internal controls with the CAE, and understand how these controls will be tested during the year.	Report to the board on issues relating to internal controls, with emphasis on management's ability to override and related monitoring and testing.	Submit a comprehensive report to the board at the second quarter meeting each year. Update on anything new, or any changes to the internal control system, at every meeting.	

When to



Audit Committee Charter	Steps to Accomplish the Objective	Deliverable	Achieve (Frequency Due Date)	Date Completed
<ul style="list-style-type: none"> <li>Any related significant findings and recommendations of the independent auditors and internal audit services together with management's responses thereto</li> </ul> <p>(See the tools "Internal Control: A Tool for the Audit Committee," and "Fraud and the Responsibilities of the Audit Committee: An Overview" in this toolkit.)</p>	<p>Review these plans with the independent auditor to understand their scope with respect to key controls.</p> <p>Review with the CAE the plans for audits of other elements of the control environment.</p> <p>Determine that all internal control weaknesses are quantified, reviewed, and addressed.</p>			
<p>17. Review with management and the independent auditor the effect of any regulatory and accounting initiatives, as well as off-balance-sheet structures, if any.</p> <p>(See the tool "Management's Summary of Off-Balance-Sheet Transactions," in this toolkit.)</p>	<p>Independently, through professional reading and CPE, keep up-to-date on new developments related to the industry, and the environment in which the company operates, including any regulatory requirements it may be subject to.</p> <p>Discuss with management and the independent auditors in meetings.</p>	<p>Record discussion and any action steps in Audit Committee meeting minutes.</p>	<p>Review as necessary.</p>	
<p>18. Review with management, the independent auditors, and the CAE, the interim annual financial report before it is filed with the Securities and Exchange Commission (SEC) or other regulators.</p>	<p>At a minimum, meet by telephone prior to any earnings release (annual or quarterly) and any SEC filings such as 10-K, 10-Q, 8-K.</p>	<p>Audit Committee approval of the press release, and/or SEC filings.</p>	<p>Review each quarter and as needed.</p>	
When to				

## The AICPA Audit Committee Toolkit

Audit Committee Charter	Steps to Accomplish the Objective	Deliverable	Achieve (Frequency Due Date)	Date Completed
19. Review with each public accounting firm that performs an audit: <ul style="list-style-type: none"> <li>• All critical accounting policies and practices used by the company.</li> <li>• All alternative treatments of financial information within generally accepted accounting principles that have been discussed with management of the company, the ramifications of each alternative, and the treatment preferred by the company.</li> </ul> (See the tool “Issues Report from Management” in this toolkit.)	Discuss each matter, and related matters that may come to the attention of the Audit Committee and/or the independent auditors through this process. Create an action plan and follow-up plan as necessary.	Submit reports and documentation of discussions and resolution of disagreements.	Review, at least annually, and/or in conjunction with the year-end audit.	
20. Review all material written communications between the independent auditors and management, such as any management letter or schedule of unadjusted differences.	Discuss each item with the independent auditors and management (including the CAE) and conclude on the appropriateness of the proposed resolution.	Submit reports and documentation of discussions, resolution of issues, and the action plan for any items requiring follow-up and monitoring.	Review, at the completion of the independent audit.	

When to

Audit Committee Charter	Steps to Accomplish the Objective	Deliverable	Achieve (Frequency Due Date)	Date Completed
<p>21. Review with management and the independent auditors:</p> <ul style="list-style-type: none"> <li>• The company's annual financial statements and related footnotes</li> <li>• The independent auditors' audit of the financial statements and their report thereon</li> <li>• The independent auditors' judgments about the quality, not just the acceptability, of the company's accounting principles as applied in its financial reporting</li> <li>• Any significant changes required in the independent auditors' audit plan</li> <li>• Any serious difficulties or disputes with management encountered during the audit</li> <li>• Matters required to be discussed by Statement on Auditing Standards (SAS) No. 61, <i>Communication With Audit Committees</i> (AICPA, <i>Professional Standards</i>, vol. 1, AU sec. 380), as amended, related to the conduct of the audit.</li> </ul>	<p>Discuss each matter, and others that may come to the attention of the audit committee through this process, with management (including the CAE) and the independent auditors.</p> <p>Review with management the course of action to be taken for any action requiring follow-up.</p> <p>Monitor any follow-up action that requires continued audit committee intervention.</p> <p>(See the tool "<a href="#">Discussions to Expect from the Independent Auditor</a>," in this toolkit.)</p>	<p>Submit reports and documentation of discussions, resolution of disagreements, or action plan for any item requiring follow-up.</p>	<p>Review at the completion of the independent audit.</p>	

When to

Audit Committee Charter	Steps to Accomplish the Objective	Deliverable	Achieve (Frequency Due Date)	Date Completed
22. Review with the general counsel and the CAE legal and regulatory matters that, in the opinion of management, may have a material impact on the financial statements, related company compliance policies, and programs and reports received from regulators.	Discuss whether the company is in compliance with laws and regulations that govern the environment(s) and industry(ies) in which it operates, as well as other applicable laws and regulations.	Report to the board that the review has taken place and any matters that need to be brought to its attention.	Review at each meeting.	
23. Periodically review the company's code of conduct to ensure that it is adequate and up-to-date.  Review with the CAE and the company's general counsel the results of their review of the monitoring of compliance with the company's code of conduct.	Review results with the CAE and general counsel. Consider any adjustments that may be necessary to the company's code of conduct.  Consider steps that may need to be taken to ensure that compliance is at the highest possible level.	Report to the board that the review of the code of conduct was done.  Recommend changes to the code of conduct to the board as needed.	Review annually at the fourth quarter meeting.  Review any significant findings as they arise.	
24. Review the procedures for the receipt, retention, and treatment of complaints received by the company regarding accounting, internal accounting controls, or auditing matters that may be submitted by any party internal or external to the organization.  Review any complaints that might have been received, current status, and resolution if one has been reached.	Review procedures with CAE and the general counsel.  Review all complaints that have been received and the status of resolution.  Ensure that proper steps are taken to investigate complaints and resolve timely.  (See also the tool "Tracking Report: Anonymous Submission of Suspected Wrongdoing (Whistleblowers)" in this toolkit.)	Review an original of each complaint received, no matter the media used to submit. Discuss the status or resolution of each complaint.  Review a cumulative list of complaints submitted to date to review for patterns or other observations.	Review at each meeting.	

When to

Audit Committee Charter	Steps to Accomplish the Objective	Deliverable	Achieve (Frequency Due Date)	Date Completed
25. Review procedures for the confidential, anonymous submission by employees of the organization of concerns regarding questionable accounting or auditing matters. Review any submissions that have been received, the current status, and the resolution if one has been reached.	Review procedures with the CAE and the general counsel. Review all complaints that have been received and the status of resolution. Ensure that proper steps are taken to investigate complaints and resolve timely.	Review an original of each complaint received no matter the media used to submit. Discuss the status of resolution of each complaint. Review a cumulative list of complaints submitted to date to review for patterns or other observations.	Review at each meeting.	
26. The Audit Committee will perform such other functions as assigned by law, the company's charter or bylaws, or the board of directors.	Monitor developments in the regulatory, legislative, and legal environments and respond to any new requirements as needed.		Review new business, at all meetings	
27. The Audit Committee will evaluate the independent auditors and internal auditors.	Use information from executive sessions conducted throughout the year. Use a formal assessment tool for each group. (See the tools "Evaluating the Internal Audit Team: Guidelines and Questions," and "Evaluating the Independent Auditor: Questions to Consider" in this toolkit.) See also the tool "Tracking Report: Anonymous Submission of Suspected Wrongdoing (Whistleblowers)" in this toolkit.)	Submit recommendations for change in process and procedures. For independent auditors, request RFPs if changes are being considered.	Review after completion of the annual audit.	

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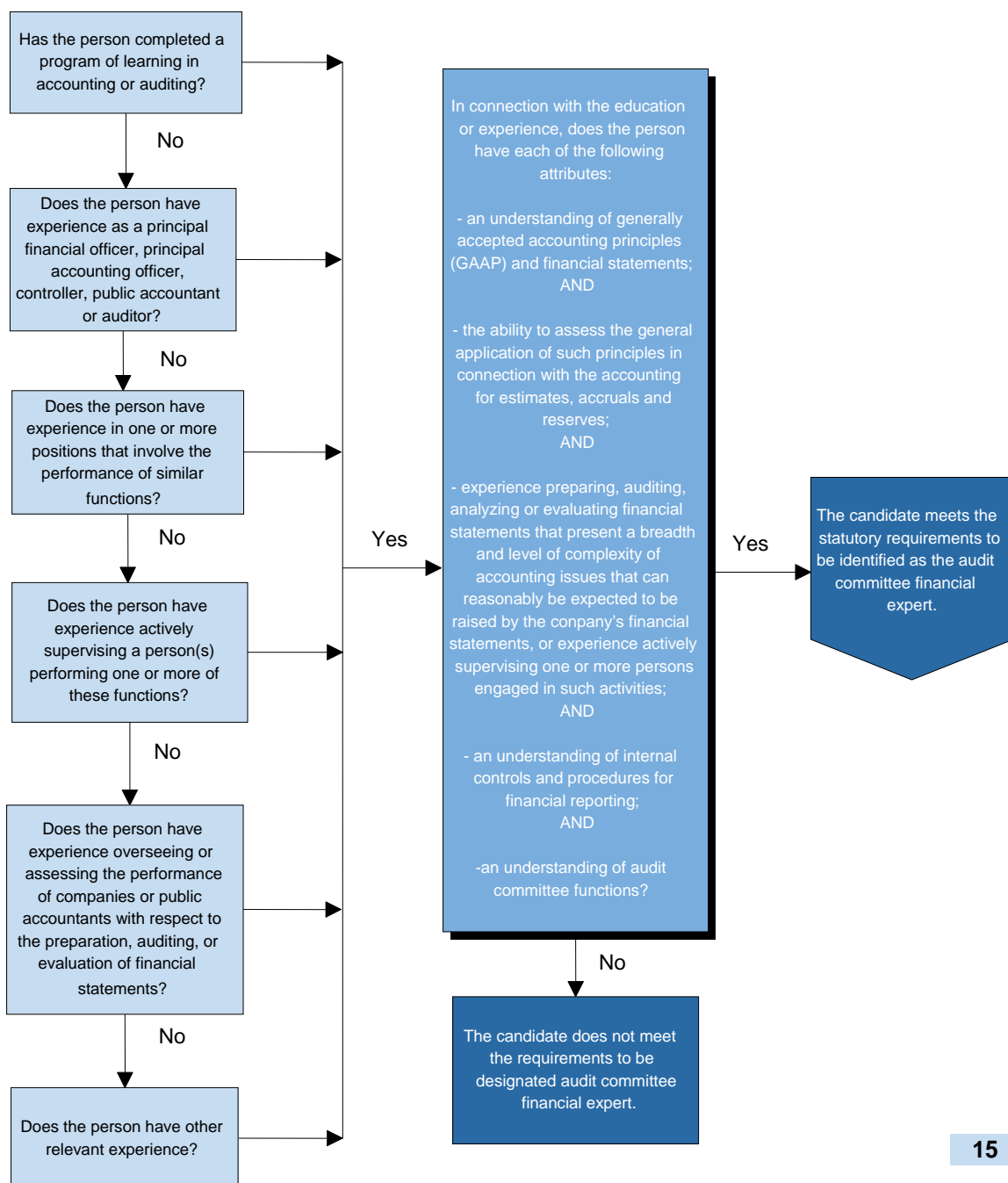
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Audit Committee Charter	Steps to Accomplish the Objective	Deliverable	Achieve (Frequency Due Date)	Date Completed
28. The Audit Committee will review its effectiveness.	The Audit Committee will conduct a self-assessment and 360-degree evaluation of all members. (See the tool “ <a href="#">Conducting an Audit Committee Self-Evaluation: Guidelines and Questions</a> ,” in this toolkit.)	Discuss recommendations for improving the effectiveness of the Audit Committee with the board of directors (BOD). Record in BOD minutes.	Review annually.	
29. Create an agenda for the ensuing year or review and approve the agenda submitted by the CAE.	Complete the “Audit Committee Charter Matrix.” (Use this tool as a sample, and tailor it to your organization.)		Review at the fourth quarter meeting for the upcoming year.	
30. Oversee the preparation of an annual report of the Audit Committee as required by the rules of the SEC and the annual affirmation required by the appropriate listing exchange, if necessary. When required by SEC rules, include in the annual Proxy Statement for the Company a report of the Committee in accordance with the Proxy Rules promulgated by the SEC.	Review and discuss the report prepared by the CAE.	Annual report finalized and issued per SEC regulations and regulations of the listing exchanges as appropriate.	Review annually at the first quarter meeting.	

## Audit Committee Financial Expert Decision Tree

**PURPOSE OF THIS TOOL:** The decision tree below illustrates how the audit committee might evaluate a candidate for consideration as their financial expert. More information on defining the term *financial expert* can be found in “SEC Rule on Audit Committee Financial Experts” elsewhere in the toolkit.

### Audit Committee Financial Expert





## Conducting an Audit Committee Executive Session: Guidelines and Questions

**PURPOSE OF THIS TOOL:** Although it is generally accepted that audit committees should hold executive sessions with various members of the executive management, leaders of the financial management team, the leader of the internal audit team, and the independent auditor, the audit committee member may not realize the type of questions and the extent of the questions they should ask. This tool is intended to help the audit committee ask the right *first* questions, bearing in mind that the audit committee should have the necessary expertise to evaluate the answers and the insight to identify the appropriate follow-up question. See the “Other Questions for Management” section of this tool for possible follow-up questions audit committee members can ask key members of the financial management team in order to improve their understanding of the day-to-day operating environment and management team’s decision-making processes and interactions.

### What Is an Executive Session?

An executive session is a best practice that could be employed by audit committees for any reason, but here we are advocating that the executive session be used to meet with key members of the executive management and financial management teams on a one-on-one basis. Executive sessions should occur at every meeting of the audit committee, though not every individual need be in an executive session at every meeting. For example, it is appropriate for the chief audit executive (CAE) and the independent auditor to have an executive session at every meeting, but the director of financial reporting might be in executive session with the audit committee only at the meeting before year-end results are released.

During an executive session meeting, minutes are (usually) not recorded, and when meeting with members of the financial management team, anyone who is not a member of the audit committee is excluded from the meeting. The purpose is to ask questions of various members of the financial management staff in a safe environment. It is important that, when meeting with the controller for example, the CFO not be in the room. Executive sessions should be a matter of routine at every audit committee meeting, and not on an exception basis. The audit committee should avoid situations of asking in an open session whether an individual has anything to discuss in an executive session—that question alone could put the individual in an awkward position with others in the company.

Asking open-ended questions in this kind of environment could be a major source of information for the audit committee. This tool includes examples of the kinds of questions the audit committee should ask. These are meant to be sample questions to help start a conversation and create dialogue between the individual and the audit committee. *These sample questions are not intended to be a checklist.* Audit committee members need to be financially sophisticated enough to understand the answers to the questions and to use these answers to develop appropriate follow-up questions. Since it will not be unusual to ask similar questions of key executives, the independent auditor and/or the internal auditor, a comparison of their respective responses could be a good source of insight. Depending on the answers,



follow-up action may also be necessary, and the audit committee must be prepared to take that action. The most important thing to do when conducting an executive session is to *listen to the answers that are given and follow-up on anything that you do not understand!*

Note that the questions for the executive session are such that the discussants may not feel free to answer honestly in the open environment but are comfortable in the “safety” of an executive session. In addition, there may be other information that the audit committee wants to know. Following the suggested executive session questions is an associated section of follow-up questions, “Other Questions for Management.” An executive session may not be necessary for these questions, which nevertheless may elicit information the audit committee wants or needs.

Audit committee members should also consider the history of the company, the industry in which it operates, the current economic climate, the competitive environment, etc., when asking questions in executive session. Finally, each executive session should be concluded with a reminder to the member of management, that audit committee members are accessible even outside the meeting, and that they should feel free to reach out to the audit committee member at other times if the need arises.

It is important to note that not every organization will have different individuals in each position, as assumed in the following questions. Nevertheless, the audit committee should be aware of the functions that are part of dual roles, and adjust the questions accordingly. For example, in a small company, the CFO and controller might share the duties of the director of financial reporting. The audit committee should explore how a function or role is accomplished, and compose questions accordingly. Also, the audit committee should consider and take into account other roles in the organization. It may be that other people within an organization should also be asked to meet with the audit committee in executive session.

**INSTRUCTIONS FOR USING THIS TOOL:** This tool is intended to help the audit committee ask the right *first* questions, bearing in mind that the audit committee should have the necessary expertise to evaluate the answers and the insight to identify the appropriate follow-up question. Audit committee members should also refer to the section “Other Questions for Management” for additional questions. These additional questions, while not of a nature requiring an executive session, may still provide the audit committee with insights into the actions of management and the company.

Conducting an Executive Session— Sample Questions		Comments
<i>Chief Financial Officer</i>		
1. Do you believe the financial statements fairly present the company’s financial position? (Note: In a public company, the CFO is required to make a certification to the Securities and Exchange Commission (SEC) on the fairness of the financial statements. An alternative question might be to ask if the CFO has made the required certifications with respect to the financial statements, and was comfortable in doing so.)		
2. Do you believe the disclosures are adequate and are understandable by the average investor?		
3. Are you satisfied that an appropriate audit was performed by the independent auditors?		
4. Are you aware of any situations of earnings management in the company?		
5. Are you aware of any current or past fraud occurrence or any kind of fraud in the organization? Do you know of any situations in which fraud could occur?		
6. Discuss areas in which an accounting treatment could be construed as aggressive. Has the organization taken any tax positions that could be construed as aggressive?		
7. Is there any activity at the executive level of management that you consider to be a violation of laws, regulations, generally accepted accounting principles (GAAP), professional practice, or the mores of business?		

Conducting an Executive Session— Sample Questions		Comments
<i>Chief Financial Officer (cont.)</i>		
8. Have you encountered any situations in which the organization complied with legal minimums of behavior, yet failed to go the extra mile to demonstrate its commitment to the highest ethical standards?		
9. Is there any activity in the organization that you are uncomfortable with or consider unusual, or that warrants further investigation?		
10. Do you feel comfortable raising issues without fear of retribution?		
11. Are there any questions we have <i>not</i> asked that should have been asked? If so, what are those questions?  <i>See additional questions in the section “Other Questions for Management” of this tool.</i>		
<i>Chief Executive Officer</i>		
1. Do you believe the financial statements fairly present the company’s financial position? (Note: In a public company, the CEO is required to make a certification to the Securities and Exchange Commission (SEC) on the fairness of the financial statements. An alternative question might be to ask if the CEO has made the required certifications with respect to the financial statements, and was comfortable in doing so.)		
2. Do you believe the disclosures are adequate and are understandable by the average investor?		
3. Are you satisfied that an appropriate audit was performed by the independent auditors?		
4. Are you aware of any situations of earnings management in the company?		
5. Are you aware of any disagreements between management of the company and the independent auditors?		
6. Are you aware of any disagreements between management and the internal auditors?		
Sample Questions		Comments

Chief Executive Officer (cont.)	
7. Is there any activity at the executive level of management that you consider to be a violation of laws, regulations, GAAP, professional practice, or the mores of business?	
8. Have you encountered any situations in which the organization complied with legal minimums of behavior, yet failed to go the extra mile to demonstrate its commitment to the highest ethical standards?	
9. Is there any activity in the organization that you are uncomfortable with or consider unusual, or that warrants further investigation?	
10. Are there any questions we have <i>not</i> asked that should have been asked? If so, what are those questions?  <i>See additional questions in the section "Other Questions for Management" of this tool.</i>	
Chief Audit Executive (leader of Internal Audit Team)	
1. Overall, is management cooperating with the internal audit team? Does management have a positive attitude in responding to findings and recommendations, or is it insecure and defensive of findings?	
2. Has management set an appropriate "tone at the top" with respect to the importance of and compliance with the internal control system around financial reporting?	
3. Are you aware of any current or past occurrence of any type of fraud in the organization? Do you know of any situations where fraud could occur?	
4. Discuss areas in which there is an accounting treatment that could be construed as aggressive. Has the organization taken any tax positions that could be construed as aggressive?	

5. Have you encountered any situations in which the organization complied with legal minimums of behavior, yet failed to go the extra mile to demonstrate its commitment to the highest ethical standards?	
6. Do you have the freedom to conduct audits as necessary throughout the company?	
7. Were you restricted or denied access to requested information?	
8. Have you been pressured to change findings, or minimize the language in those findings so as to not reflect badly on another member of management? Are findings and recommendations given the level of discussion needed to properly satisfy any issues raised, to your satisfaction?	
9. Do you feel comfortable raising issues without fear of retribution?	
10. Is there any activity at the executive level of management that you consider to be a violation of laws, regulations, GAAP, professional practice, or the mores of business?	
11. Have you encountered any situations in which the organization complied with legal minimums of behavior, yet failed to go the extra mile to demonstrate its commitment to the highest ethical standards?  <i>See additional questions in the section “Other Questions for Management” of this tool.</i>	
<b>Controller</b>	
1. Do you believe the financial statements fairly present the company’s financial position?	
2. Do you believe the disclosures are adequate and are understandable to the average investor?	

## Conducting an Executive Session— Sample Questions

## Comments

*Controller (cont.)*

3. If you were the CFO, how would you change the financial statements and accompanying footnotes?	
4. Are you aware of any current or past occurrence of any type of fraud in the organization? Do you know of any situations in which fraud could occur?	
5. Discuss areas in which there is an accounting treatment that could be construed as aggressive. Has the organization taken any tax positions that could be construed as aggressive?	
6. Are you satisfied that an appropriate audit was performed by the independent auditors?	
7. Are you aware of any situations of earnings management in the company?	
8. Are you aware of any disagreements between the management of the company and the independent auditors?	
9. Has management set an appropriate “tone at the top” with respect to the importance of and compliance with the internal control system around financial reporting?	
10. Do you feel comfortable raising issues without fear of retribution?	
11. Have you encountered any situations in which the organization complied with legal minimums of behavior, yet failed to go the extra mile to demonstrate its commitment to the highest ethical standards?	
12. Is there any activity at the executive level of management that you consider to be a violation of laws, regulations, GAAP, professional practice, or the mores of business?	

**Conducting an Executive Session—  
Sample Questions**

**Comments**

*Controller (cont.)*

**The AICPA Audit Committee Toolkit**

13. Is there any activity in the organization that you are uncomfortable with or consider unusual, or that warrants further investigation?	
14. Are there any questions we have <i>not</i> asked that should have been asked? If so, what are those questions?  <i>See additional questions in the section “Other Questions for Management” of this tool.</i>	
<b>Director of Financial Reporting</b>	
1. Are there any issues since our last meeting that you wish to discuss with the audit committee?	
2. Are you aware of any current or past occurrences of any type of fraud in the organization? Do you know of any situations in which fraud could occur?	
3. Discuss areas in which there is an accounting treatment that could be construed as aggressive.	
4. Are you aware of any situations of earnings management in the company?	
5. Do you believe the financial statements and related disclosures adequately convey the financial situation in the company to an average investor?	
6. Now that you have the opportunity, is there anything you want to tell the audit committee? Is there anything else that we need to know?	
7. Are you aware of any disagreements between management of the company and the independent auditors?	
8. Do you feel comfortable raising issues without fear of retribution?	

<b>Conducting an Executive Session— Sample Questions</b>		<b>Comments</b>
<b>Director of Financial Reporting (cont.)</b>		
9. Is there any activity at the executive level of management that you consider to be a violation of laws, regulations, GAAP, professional practice, or the mores of business?		

10. Is there anything going on in the organization with which you are uncomfortable?	
11. Are there any questions we have <i>not</i> asked that should have been asked? If so, what are those questions?  <i>See additional questions in the section "Other Questions for Management" of this tool.</i>	
<b>General Counsel</b>	
1. Are you satisfied with the presentation of information about the company in the 10-K, 10-Qs, proxy statements, and other filings?	
2. Are you aware of any issues that could cause embarrassment to the company?	
3. Have you ever been told anything in confidence or otherwise that would embarrass the company if it were known publicly?	
4. Are you aware of any situations of earnings management in the company?	
5. Are there any items that you have discussed with the CEO, CFO or other officers, or outside counsel, that the audit committee is not already aware of?	
6. Are you aware of any disagreements between management of the company and the independent auditors?	
7. Do you feel comfortable raising issues without fear of retribution?	
8. Is there any activity at the executive level of management that you consider to be a violation of laws, regulations, GAAP, professional practice, or the mores of business?	
<b>Conducting an Executive Session— Sample Questions</b>	
<b>Comments</b>	
<b>General Counsel (cont.)</b>	
9. Have you encountered any situations in which the organization complied with legal minimums of behavior, yet did not go the extra mile to demonstrate its commitment to the highest ethical standards?	



10. Is there any activity in the organization that you are uncomfortable with, consider unusual or that warrants further investigation?	
11. Are there any questions we have <i>not</i> asked that should have been asked? If so, what are those questions?  <i>See additional questions in the section “Other Questions for Management” of this tool.</i>	
<b>Chief Information Officer</b>	
1. Is there any activity in the organization that you are uncomfortable with or consider unusual, or that warrants further investigation?	
2. Do you feel comfortable raising issues without fear of retribution?	
3. Are there any questions we have <i>not</i> asked that should have been asked? If so, what are those questions?  <i>See additional questions in the section “Other Questions for Management” of this tool.</i>	
<b>Independent Auditor</b>	
<p>Note that there are certain communications that are required between the independent auditor and the audit committee. A separate tool, “Discussions to Expect from the Independent Auditor,” has been prepared for the audit committee to ensure completeness of the committee’s required communication with the independent auditor. These suggested questions are meant to be in addition to the required communications.</p>	

## Conducting an Executive Session—Sample Questions

### *Independent Auditor (cont.)*

1. Explain the process your firm goes through to assure that all of your engagement personnel are independent and objective with respect to our audit. Particularly, with respect to nonaudit services, how do those services affect the work that you do or the manner in which the engagement team or others are compensated? Are you aware of any anticipated event that could possibly impair the independence, in fact or in appearance, of the firm and any member of the engagement team?

Comments:
2. Has management, legal counsel, or others made you aware of anything that could remotely be considered a violation of laws, regulations, GAAP, professional practice, or the ethics of business?
Comments:
3. Are there any areas of the financial statements including the notes, in which you believe we could be more explicit or transparent, or provide more clarity to help a user better understand our financial statements?
Comments:
4. Have you expressed any concerns or comments to management with respect to how our presentation, including the notes or Management's Discussion & Analysis could be improved?
Comments:
5. Which accounting policies or significant business transactions do you think an investor will have trouble understanding based on our disclosure? What additional information could (should) we provide?
Comments:
<b>Conducting an Executive Session—Sample Questions</b>
<i>Independent Auditor (cont.)</i>

Comments:
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over financial reporting.
<i>Comments:</i>

<i>Comments:</i>
8. Discuss your impressions of the performance of the CAE in terms of the completeness, accuracy, and faithfulness of the financial reporting process.

<i>Comments:</i>
9. Has the firm been engaged to provide any services besides the independent audit of which the audit committee is not already aware?

<i>Comments:</i>

10. How can management improve in terms of setting an appropriate “tone at the top”?
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## Conducting an Executive Session—Sample Questions

### *Independent Auditor (cont.)*

<i>Comments:</i>


Comments:


12. Describe any situation in which you believe management has attempted to circumvent the spirit of GAAP, but has yet complied with GAAP.

Comments:


14. Are there any questions we have *not* asked that you wish to discuss with the audit committee?

*See additional questions in the section "Other Questions for Management" of this tool.*

Comments:


## Other Questions for Management

**PURPOSE OF THIS SECTION:** It is important for the audit committee to have a solid familiarity with the management team, since the committee relies heavily on them. In some large companies, there is an expectation that members of the board will interact with members of management one-on-one on a regular basis. However, such interaction is not always possible. This section lists other questions that the audit committee may wish to address to key members of the financial management team. These

questions need not be asked in an executive session, but can be addressed more informally as opportunities arise.

Other Questions for Management		Comments
<i>Chief Financial Officer</i>		
1. Describe your working relationship with the CEO.		
2. If you were the partner-in-charge of the audit, what would you do differently?		
3. Are you aware of any disagreements between management of the company and the independent auditors?		
4. How frequently do you meet with the lead audit partner? Describe your relationship with him or her.		
5. Are you aware of any disagreements between management and the internal auditors?		
6. Describe your relationship with the chief audit executive. Discuss your impressions of his or her performance.		
7. How do you interface with the internal audit function?		
8. Has the independent auditor been engaged for any services other than the annual audit of which the audit committee is not already aware?		
9. What issues arose from the Sarbanes-Oxley internal control documentation and validation effort?		
10. What aspects of the business put the most strain on company liquidity? On the company's capital position?		
11. Are the computer systems upon which you rely integrated, or is manual intervention required to integrate your systems?		
Other Questions for Management		Comments
<i>Chief Financial Officer (cont.)</i>		
12. Which systems are the most difficult to work with?		
13. Are there any new systems or functionality that you would like to purchase but have delayed due to cost considerations?		
14. What procedures or oversight do you apply to manual journal entries that are proposed during the book-closing process?		

## Conducting an Audit Committee Executive Session

15. Do each of the accounting and finance departments of the company have adequate personnel, both in numbers and quality, to meet all their obligations?	
16. What are the most difficult challenges facing the finance organization today?	
17. Which departments might benefit the most from additional people resources?	
18. What are the personnel turnover rates in the accounting and finance teams for the last year?	
19. Which of the company's lines of business and operations had the biggest negative impact on earnings this past year? The biggest positive impact?	
20. What, if any, changes do you believe need to be made in these areas?	
21. Describe your working relationship with the heads of the respective business units.	
22. What are the biggest risks facing the company in the next year? What steps do you think the company should take to address those risks?	
23. What are the biggest risks facing the company over the long term? What measures do you believe the company should take to address those risks?	

Other Questions for Management	Comments
<i>Chief Financial Officer (cont.)</i>	
24. In light of the fact that you certified to your review of the financial statements that the financial statements do not contain any untrue statement of material fact or omit material facts, that they present fairly the results of operations, and that you, along with the CEO, take responsibility for the design of the internal control system and have evaluated the effectiveness of the internal control system, what were your areas of concern, and how did you satisfy yourself as to their resolution?	
<i>Chief Executive Officer</i>	

1. Discuss your impressions of the performance of the chief audit executive (CAE).	
2. Has the independent auditor been engaged for any services other than the annual audit of which the audit committee is not already aware?	
3. Is there any activity at the executive level of management that you consider to be a violation of laws, regulations, generally accepted accounting practices (GAAP), professional practice, or the mores of business?	
4. Have you encountered any situations where the organization complied with legal minimums of behavior, yet failed to go the extra mile to demonstrate its commitment to the highest ethical standards?	
5. What issues arose from the Sarbanes-Oxley internal control documentation and validation effort?	
6. Which of the company's lines of business and operations had the biggest negative impact on earnings this past year? The biggest positive impact?	
7. What, if any, changes do you believe need to be made in these areas?	
8. Describe your working relationship with the heads of the respective business units.	
9. What are the biggest risks facing the company in the next year? What steps do you think the company should take to address those risks?	

Other Questions for Management	Comments
<i>Chief Executive Officer (cont.)</i>	

11. In light of the fact that you certified to your review of the financial statements that the financial statements do not contain any untrue statement of material fact or omit material facts, that they present fairly the results of operations, and that you, along with the CFO, take responsibility for the design of the internal control system and have evaluated the effectiveness of the internal control system, what were your areas of concern, and how did you satisfy yourself as to their resolution?	
<i>Chief Audit Executive (leader of Internal Audit function)</i>	
1. What procedures do you apply to the review of manual journal entries made during the book-closing process, and to other entries that could be termed as a management override of the internal control system around financial reporting?	
2. If you were the CEO, how would you do things differently in the internal audit department?	
3. Do you believe you have adequate resources available to you to fulfill the charge of the department? If not, what additional resources are needed?	
4. Did you encounter any disagreements or difficulties between the internal audit team and the independent auditors in connection with the recently completed audit of the company's financial statements? How will you approach the financial statement audit differently next year?	
5. What critical risks are being monitored by the internal audit team on a periodic or regular basis? How do you address the continuous auditing of these critical risks, and is automation and integrated system reporting assisting you in this effort?	
6. Are you aware of any other disagreements between management of the company and the independent auditors?	

Other Questions for Management	Comments
<i>Chief Audit Executive (leader of Internal Audit function) (cont.)</i>	
7. Are there any disagreements between the internal audit team and management?	
8. Has the independent auditor been engaged for any services other than the annual audit of which the audit committee is not already aware?	
9. What issues arose from the Sarbanes-Oxley control documentation and validation effort?	
10. Are the computer systems upon which you rely integrated, or is manual intervention required to integrate your systems?	



**The AICPA Audit Committee Toolkit**

11. Do you monitor payments to the independent audit firm to ensure that the audit firm is only providing services that are related to the audit, or other services that have been preapproved by the audit committee?	
12. Which of the company's lines of business and operations had the biggest negative impact on earnings this past year? The biggest positive impact?	
13. What, if any, changes do you believe need to be made in these areas?	
14. Describe your working relationship with the heads of the respective business units.	
15. What are the biggest risks facing the company in the next year? What steps do you think the company should take to address those risks?	
16. What are the biggest risks facing the company over the long term? What measures do you believe the company should take to address those risks?	
<b>Controller</b>	
1. Has the independent auditor been engaged for any services other than the annual audit of which the audit committee is not already aware?	
2. If you were the partner-in-charge of the audit, what would you do differently?	
3. Discuss your impressions of the performance of the chief audit executive.	

<b>Other Questions for Management</b>		<b>Comments</b>
<b>Controller (cont.)</b>		
4. Are the computer systems upon which you rely integrated, or does it require manual intervention to integrate your systems?		
5. What procedures do you apply to review manual journal entries proposed during the book-closing process, or to other entries that could be termed as a management override of the internal control system around financial reporting?		
6. Which of the company's lines of business and operations had the biggest negative impact on earnings this past year? The biggest positive impact?		

7. What, if any, changes do you believe need to be made in these areas?	
8. What are the biggest risks facing the company in the next year? What steps do you think the company should take to address those risks?	
9. What are the biggest risks facing the company over the long term? What measures do you believe the company should take to address those risks?	
10. Have you been asked to provide assurance to the CFO and CEO with respect to your role in the financial reporting process, similar to the certification that the CEO and CFO must make to regulatory bodies?	
<i>Director of Financial Reporting</i>	
1. How could the financial statements and related disclosures be improved?	
2. Are the computer systems upon which you rely integrated, or is manual intervention required to integrate your systems?	
3. Have you been asked to provide assurance to the CFO and CEO with respect to your role in the financial reporting process, similar to the certification that the CEO and CFO must make to regulatory bodies?	

Other Questions for Management	Comments
<i>General Counsel</i>	
1. Discuss your impressions of the performance of the chief audit executive.	
2. Has the independent auditor been engaged for any services other than the annual audit of which the audit committee is not already aware?	

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3. Describe your working relationship with the heads of the respective business units.	
4. What are the biggest risks facing the company in the next year? What steps do you think the company should take to address those risks?	
5. What are the biggest risks facing the company over the long term? What measures do you believe the company should take to address those risks?	
<b>Chief Information Officer</b>	
1. Are you satisfied with the integrity of the information running through the systems in the company? How could technology improve the integrity of the information?	
2. What exposure is associated with the company's firewalls?	
3. If you had an unlimited budget, how would you spend money to improve the company's information architecture?	
4. What do you consider your critical risk areas?	
5. Describe your relationship with the CFO and other key people in the accounting and finance team.	
6. Are manual journal entries identified and approved? Are they somehow brought to the attention of the CAE, or other officer(s) who did not have a hand in creating the journal entries?	
7. Is documentation updated every time there is a change to the internal controls process?	
8. Describe your working relationship with the heads of the respective business units.	

Other Questions for Management		Comments
<b>Chief Information Officer (cont.)</b>		
9. What are the biggest risks facing the company in the next year? What steps do you think the company should take to address those risks?		
<b>Independent Auditor</b>		

11. Have you been asked to provide assurance to the CFO and CEO with respect to your role in the financial reporting process, similar to the certification that the CEO and CFO must make to regulatory bodies?

### Running an Audit Committee Executive Session

[illegible]




## Engaging Independent Counsel and Other Advisers

**PURPOSE OF THIS TOOL:** The Sarbanes-Oxley Act of 2002 gives audit committees the authority to engage independent counsel and other advisers as it deems necessary to carry out its duties. The Act further requires that companies provide appropriate funding for payment of outside advisers to the audit committee. This tool is intended to assist audit committee members in understanding the process of engaging independent counsel and other advisers if needed.

When selecting independent counsel or other advisers (expert/adviser) for an engagement within the company, the audit committee should not only consider the education, training, and experience of the specialists and staff assistants actually performing the work, but it should determine that the service provider: (1) maintains integrity and objectivity; (2) is free of conflicts of interest with respect to the members of the audit committee and the company; (3) has the expertise and resources necessary to do the work it is under consideration to do; and (4) has a reputation for reliability, among other considerations.

Although the nature of every engagement will be different, the initial steps the audit committee (or its designee) should undertake when engaging external resources include the following:

1. Determine that the expert/adviser has the competence and experience to perform the requested service. Check references with other clients of the service provider.
2. Determine whether the expert/adviser has a conflict of interest with respect to the company. Such a conflict might arise if the expert/adviser has a relationship with the external auditor, or if they provide service to a competitor. Depending on the nature of the service to be offered, a conflict could arise if the expert/adviser has a relationship with a member of the board of directors, or a member of the company's management. Be aware of other potential conflicts of interest that may distract, or undermine, the work to be done.
3. Determine if the expert/adviser has sufficient resources to perform the work in the time frame specified by the audit committee.
4. Evaluate the scope of work to be performed and other issues, including the proposed plan for payment of fees and expenses.
5. Make sure all parties (including management and the expert/adviser) understand that the audit committee is the owner of the service relationship. Make sure that management understands that the expert/adviser is working on behalf of the audit committee and the audit committee expects management to be fully cooperative and forthcoming with respect to any information that may be requested.
6. Determine the criteria that will be used to measure the expert's/adviser's work and document those criteria in an agreement with the service provider.

As with any relationship, communication and expectations management is important.



## Guidelines for Hiring the Chief Audit Executive (CAE)

**PURPOSE OF THIS TOOL:** The internal audit function in the company is a key mechanism in the internal control structure, so careful efforts must be taken in hiring the right chief audit executive (CAE), one that fits the company needs with the necessary technical expertise, but also one that meets other requirements (industry experience, temperament, integrity, management and human relationship skills, etc.).

### Role of the Chief Audit Executive

A critical activity of the audit committee is to be involved in the hiring of the CAE of the company. The CAE will have a high degree of interaction with the audit committee, so the audit committee should be comfortable working with this person. In many companies, the CAE will report functionally to the audit committee and administratively to a senior executive of the company.

### CAE Qualifications

In general, candidates for a CAE position should have distinguished themselves professionally by earning a CPA and/or certified internal auditor (CIA) credential, significant experience (10 years or more) in a management role, and strong technical skills in accounting and auditing. In addition, because of the breadth of experience it offers, the audit committee should seek candidates that have experience in public accounting (or its equivalent) and possibly an advanced business degree such as an MBA.

Additionally, the AICPA's competency self-assessment tool (CAT) may be a useful exercise for candidates to complete, provided they agree to share results with the audit committee. The CAT is available at <https://www.cpa2biz.com/CPEConferences/CAT.htm>.

**INSTRUCTIONS FOR THIS TOOL:** The following questions are ones the audit committee should consider asking candidates that have passed the initial employment screening by either the company's human resources department or an outside recruiting firm. Note that some sample questions may not be appropriate for your organization or the candidate.

Chief Audit Executive—Sample Candidate Interview Questions	Interviewer Notes
What do you consider to be internal audit's role within the business?	
What do you see as the biggest challenges for an internal audit team in the short run (3 to 6 months), medium term (6 to 12 months) and over the next 2 to 3 years?	
What experience do you have in this industry, and how do you plan to keep abreast of the significant developments relevant to internal audit in this industry? What is your experience in addressing different business practices in different countries?	
Have you ever been offered a gratuity or a payment that could be construed as a bribe? What were the circumstances, and how did you handle the situation?	
Have you worked with audit committees in the past? What processes have you put in place to keep the audit committee fully and appropriately informed? In the course of a year, what is the typical number of meetings/communications between the CAE and the audit committee (chair)?	
Give some examples of situations you have faced that required special meetings with the audit committee in executive session as a result of disagreements with management. How were these situations resolved with management? Have there been situations in which management has tried to squash your recommendations or discredit your findings, and how did you respond to this? In retrospect, would you now handle these situations differently?	



Chief Audit Executive—Sample Candidate Interview Questions	Interviewer Notes
Have you worked with the Committee of Sponsoring Organizations of the Treadway Commission (COSO) Internal Control Framework? How has the framework influenced your process in evaluating the adequacy of internal controls? How is this framework used to design your internal audits?	
In your previous company, what type of technology platform was used? Have you been involved in an enterprise resource planning (ERP) system implementation? What role did you play in the process and how did you make sure that the proper controls were in place when the system went live?	
Have you used technology in conducting internal audits, and how has it enhanced conducting of the internal audit? How would you recognize a problem that might exist either in the internal audit data, or in the company's records? What would you do about it?	
Do you use a formal project planning process, which is applied consistently, for all internal audits? If so, what benefits have you derived in meeting your team's goals and objectives? What is your average report cycle time from the end of fieldwork?	
How would you or the internal audit team ensure the identification of all locations required to be audited under the rules of the Sarbanes-Oxley Act with respect to section 404 on internal control? Have you ever conducted a formal risk assessment, and how have you incorporated the results into setting up an audit plan?	
What roles do the organization's strategic and technology plans play in the development of an audit plan?	
Have you gone out to divisions, subsidiaries, or locations to ensure that they have significant input into audit objectives and scopes? How is this achieved? How have you resolved differences of opinion in this area without compromising the goals you have established for an audit?	

Chief Audit Executive—Sample Candidate Interview Questions	Interviewer Notes
What role have you played in assisting divisions, subsidiaries, or locations in the implementation of recommendations?	
When you or your team conducts an internal audit, do you have a service orientation to your audit process? Do you work to improve the effectiveness and efficiency of the operations and controls in each audit area? How would you make your recommendations to management? What process would you use to resolve differences of opinion?	
Would you use a process for conducting a “customer satisfaction” survey after an internal audit is completed? How would you integrate this feedback into future audits?	
How would you ensure that the personnel in internal audit have the necessary skills to ensure an adequate understanding of divisional or departmental business?	
How many people have you managed, either as direct reports, or within an organization that you might have overseen? How would you describe your management style? Have you ever participated in a 360-degree assessment process? If so, what did you learn about yourself that surprised you? How did the results of the assessment change your behavior?	
<b>Other Notes and Questions:</b>	



## Sample Request for Proposal Letter for CPA Services (Public Company)

**PURPOSE OF THIS TOOL:** This tool includes sample language that may be used by a public company's audit committee requesting a proposal letter from qualified CPA firms when seeking a new audit service provider. As such, the sample letter may be subject to audit committee review or discussion.

*[Company Letterhead]*

*[Current Date]*

*[Managing Partner]*

*[CPA Firm]*

*[Street Address]*

*[City, State, Zip]*

Dear Sir or Madam:

Our company is accepting proposals from CPA firms to provide audit and tax services for our company in the future. We invite your firm to submit a proposal to us by \_\_\_\_\_ *[Date]* \_\_\_\_\_ for consideration. Note that the Audit Committee of the company's Board of Directors (Audit Committee) is the decision-maker in the hiring of the company's auditor in accordance with the *Sarbanes-Oxley Act of 2002* (the Act). The company is acting at the direction of the Audit Committee in sending this Request for Proposal to you. A description of the company, the services needed and other pertinent information follows:

### Background of ABC Company

ABC Company is a publicly traded manufacturer of widgets listed on the NASDAQ. Annual revenues are between \$450 and \$500 million per year, and the company employs 350 people at various locations around the U.S. The company was founded in 1983 and had its IPO in 1997. It has been profitable for the last twelve years and enjoys steady growth. The company has a December 31 year-end, with the usual filing requirements for a publicly traded company.

### Services to be Performed

Your proposal is expected to cover the following services:

1. Quarterly reviews beginning with the quarter ended on \_\_\_\_\_ *[Date]* \_\_\_\_\_ of internally prepared financial statements and the related 10-Q filings
2. Annual audit and related 10-K filing, to be completed in accordance with the requirements of the NASDAQ
3. Tax filings for the company and three wholly-owned subsidiaries

4. Auditor evaluation of management's assessment of the internal control structure

It is important to note that your firm will not be engaged to perform any additional services prohibited by the Act, the Public Company Accounting Oversight Board (PCAOB), the Securities and Exchange Commission (SEC), or any other regulator as additional rules may continually be issued. In addition, if you wish to propose on any other services to our firm that are not prohibited by the Act, the PCAOB or any other regulator, these services must be pre-approved by the Audit Committee, including tax services.

**Key Personnel**

Following is a list of key persons you may wish to contact with respect to this engagement:

Mr. Green	CEO	1-123/555-7890
Ms. Brown	CFO	1-123/555-7891
Mr. Black	General Counsel	1-123/555-7892
Mr. White	Controller	1-123/555-7893
Mr. Plain	Chairman	1-123/555-4567
Ms. Trane	Audit Comm. Chair	1-456/555-0123
Mr. Carr	Outside Counsel	1-789/555-9870

For control purposes, we ask that you make all requests for access to the company and its personnel through our Controller, Mr. White. Requests for additional information, visits to our site, review of prior financial statements and tax returns, and/or appointments with the CEO, CFO, and Audit Committee Chair should also be coordinated through Mr. White.

**Relationship With Prior CPA Service Provider**

Since the company was founded over 20 years ago, these services have been provided by XYZ, CPAs. However, that firm is no longer able to provide the services to our company. In preparing your proposal, be advised that management will give permission to contact the prior auditors.

Use this caption to describe your relationship with the prior auditor, including information that you are willing to disclose at this stage in the proposal process. CPA firms may request additional information, which you may choose to disclose only if the CPA firm signs a nondisclosure agreement.

**Other Information**

Use this space to discuss other information that a CPA firm may need to make an informed proposal on the accounting and/or auditing work that you require. As mentioned above, you should only disclose information here that you are comfortable disclosing; additional information may be available to the CPA firms interested in making a serious proposal only after signing a nondisclosure agreement.

**Your Response to This Request for Proposal**

In responding to this request, please provide the following information:

These are sample questions that you may consider asking. You should tailor these questions to your circumstances, and delete or add additional questions as appropriate.

**Background on the Firm:**

1. Detail your firm's experience in providing auditing and tax services to companies in the manufacturing sector, as well as companies of a comparable size to ABC Company.
2. Discuss your firm's quality control policies and procedures with respect to nonattest services provided to publicly traded entities for whom you provide attest services. In cases in which the firm provides both audit and nonaudit services, how does the firm make a determination of its ability to perform nonaudit services and remain independent to provide audit services?
3. Discuss commitments you will make to staff continuity, including your staff turnover experience in the last three years.
4. Identify the five largest clients your firm (or office) has lost in the past three years and the reasons.
5. Furnish standard billing rates for classes of professional personnel for each of the last three years.
6. Provide the names and contact information for other similarly sized clients of the partner and manager that will be assigned to our company.
7. Describe how and why your firm is different from other firms being considered, and why our selection of your firm as our independent auditors is the best decision we could make.
8. Describe how important ABC Company would be to your firm.
9. Include a copy of your firm's most recent peer review report, the related letter of comments, and the firm's response to the letter of comments.
10. Describe the firm's approach to the resolution of technical disagreements (a) among engagement personnel, and (b) between the firm and the client.
11. Indicate how the firm intends to comply with the requirements of the Sarbanes-Oxley Act of 2002, any rules of the PCAOB, including but not limited to the requirement for audit partner rotation.

**Experience in Our Industry**

Use this space to ask questions about the firm's experience providing services to other companies in your industry, as well as providing services to companies within your value chain—either as suppliers or customers.

**Relationship and Experience with Regulators:**

1. Detail your firm's experience in providing audit and related services to clients that are publicly traded.
2. Detail any investigation by the SEC, the PCAOB, or other regulatory agencies in which either you or the client are the target, with respect to your publicly traded clients.
3. Detail any civil or criminal litigation matter involving the firm but not necessarily the client.

4. Detail any positions taken by your firm with respect to accounting and auditing matters, with either the SEC, PCAOB, Financial Accounting Standards Board, AICPA, Federal Trade Commission, and/or others, that could be viewed as controversial and are related to our business.

### **Expected Approach to this Audit**

1. Identify the partner, manager, and in-charge accountant who will be assigned to this audit if you are successful in your bid, and provide biographical material. Indicate any complaints against them that have been leveled by the state board of accountancy or other regulatory authority, if any. Indicate any corrective actions that have been taken by the firm with respect to these people.
2. Describe how your firm will approach the audit of the company, including the use of any association or affiliate member firm personnel.
3. Set forth your fee proposal for the 20XX audit, with whatever guarantees can be given regarding fee increases in future years. Provide your proposed fee for the quarterly review work that will be required as well as the corporate tax preparation if you are proposing on the tax work. Ensure that the fee as proposed is sufficient to cover the work that you expect to perform if you are awarded this audit.

### **Evaluation of Proposals**

The Audit Committee of the Board of Directors of ABC Company will evaluate proposals on a qualitative basis. This includes a review of the firm's peer review report and related materials, interviews with senior engagement personnel to be assigned to our company, results of discussions with other clients, and the firm's completeness and timeliness in its response to us. Please submit a copy of the firm's last peer review report and related materials, as well as information on the firm's liability insurance coverage.

If you choose to respond to this request, please do so by [Date indicated earlier in the letter].

Sincerely,

Ms. Brown, CPA  
Chief Financial Officer

Ms. Trane  
Chair  
Audit Committee



## Sample Request for Proposal Letter for CPA Services (Nonpublic Organization)

**PURPOSE OF THIS TOOL:** This tool includes sample language that may be used by a nonpublic organization's management team requesting a proposal letter from qualified CPA firms when seeking a new service provider. As such, the sample letter may be subject to audit committee review or discussion, if an audit committee exists.

*[Company Letterhead]*

*[Current Date]*

*[Managing Partner]*

*[CPA Firm]*

*[Street Address]*

*[City, State, Zip]*

Dear Sir or Madam:

Our company is accepting proposals from CPA firms to provide audit and tax services for our company in the future. We invite your firm to submit a proposal to us by June 30, 20XX for consideration. A description of the company, the services needed, and other pertinent information follows:

### Background of ABC Company

ABC Company is a manufacturer of widgets. Annual revenues are between \$30 and \$50 million per year, and the company employs 35 people, mostly on the shop floor and all in one location. The company is family-owned and has a 20-year history of profitability. The company has a June 30 fiscal year-end, with a requirement to file an audited financial statement with the bank by September 30 of each year.

### Services to Be Performed

Your proposal is expected to cover the following services:

1. Quarterly reviews of internally prepared financial statements
2. Annual audit to be completed in compliance with the above filing requirement
3. Tax filings for the company and three related entities, which are real estate concerns that own the buildings on our site
4. Personal tax filings for the top five executives in the company

## **Key Personnel**

Following are key contacts for information you may seek in preparing your proposal:

Mr. Green	CEO	1-123-456-7891
Ms. Brown	CFO	1-123-456-7892
Mr. White	Controller	1-123-456-7893
Ms. Blue	Accounting Manager	1-123-456-7894

Requests for additional information, visits to our site, review of prior financial statements and tax returns, and/or appointments with the CEO or CFO should be coordinated through Mr. White, our controller. You can reach him at the number listed above.

## **Relationship With Prior CPA Service Provider**

Since the company was founded over 20 years ago, these services have been provided by XYZ, CPAs. However, that firm is no longer able to provide the services to our company since it has recently restructured. In preparing your proposal, be advised that management will give permission to contact the prior auditors.

Use this caption to describe your relationship with the prior auditor, including information that you are willing to disclose at this stage in the proposal process. CPA firms may request additional information, which you may choose to disclose only if the CPA firm signs a nondisclosure agreement.

## **Other Information**

Use this space to discuss other information that a CPA firm may need to make an informed proposal on the accounting and/or auditing work that you require. As mentioned above, you should only disclose information here that you are comfortable disclosing; additional information may be available to the CPA firms interested in making a serious proposal only after signing a nondisclosure agreement

## **Your Response to This Request for Proposal**

In responding to this request, please provide the following information:

1. Detail your firm's experience in providing auditing and tax services to companies in the manufacturing sector, as well as companies of a comparable size to ABC Company.
2. Information on whether you provide services to any company(ies) that compete with ABC.
3. Information on whether any companies for whom you provide services are part of our value chain—as either a supplier or customer of ABC.
4. Discuss commitments you will make to staff continuity, including your staff turnover experience in the last 3 years.
5. Identify the five largest clients your firm (or office) has lost in the past three years and the reasons.



***Sample RFP for CPA Services (Nonpublic Organization)***

6. Identify the partner, manager, and in-charge accountant who will be assigned to our job if you are successful in your bid, and provide biographies. Indicate any complaints against them that have been leveled by the state board of accountancy or other regulatory authority, if any. Indicate any corrective actions that have been taken by the firm with respect to these people.
7. Describe how your firm will approach the audit of the company, including the use of any association or affiliate member firm personnel.
8. Set forth your fee proposal for the 20XX audit, with whatever guarantees can be given regarding increases in future years. Provide your proposed fee for the quarterly review work that will be required as well as the corporate and executive tax preparation.
9. Furnish standard billing rates for classes of professional personnel for each of the last three years.
10. Provide the names and contact information for other similarly sized clients of the partner and manager that will be assigned to our company.
11. Describe how and why your firm is different from other firms being considered, and why our selection of your firm as our independent auditors is the best decision we could make.
12. Describe how important ABC Company would be to your firm.
13. Include a copy of your firm's most recent peer review report, the related letter of comments, and the firm's response to the letter of comments.

**Evaluation of Proposals**

ABC Company will evaluate proposals on a qualitative basis. This includes our review of the firm's peer review report and related materials, interviews with senior engagement personnel to be assigned to our company, results of discussions with other clients, and the firm's completeness and timeliness in its response to us.

As previously mentioned, if you choose to respond to this request, please do so by June 30, 20XX.

Sincerely,

Ms. Brown, CPA  
Chief Financial Officer



## Peer Review of CPA Firms: An Overview

**PURPOSE OF THIS TOOL:** This tool is prepared to educate audit committee members about the practice-monitoring programs over the accounting and auditing practices of the substantial majority of U.S. CPA firms. This tool is intended to help audit committee members understand the obligations and oversight of CPA firms. CPA firms that audit public companies are also subject to periodic inspections by the Public Company Accounting Oversight Board. See the section “Public Company Accounting Oversight Board Inspection” of this tool for a discussion of PCAOB inspection.

Over the course of the 1990s, peer review requirements for CPA firms, and the schedule for administering them, changed considerably. Currently, most CPA firms undergo a review of their accounting and auditing practice at least once every three years. This tool will help audit committee members understand the requirements for a peer review, how to interact with auditors concerning their peer review, and why the auditor’s peer review should be important to an audit committee member.

### Peer Review of a CPA Firm

A peer review of a CPA firm can be used by an audit committee as a tool to assess whether the CPA firm it hires or is considering hiring:

1. Has a system of quality control for its accounting and auditing practice that has been designed to meet the requirements of the AICPA’s Statements on Quality Control Standards (SQCSs).
2. Is complying with that system of quality control during the peer review year to provide the firm with reasonable assurance of complying with professional standards.

The AICPA’s standards regarding quality control provide requirements in the quality control areas of auditor independence, integrity, and objectivity; audit personnel management; acceptance and continuance of audit clients and engagements; audit engagement performance; and firm quality control monitoring. Professional standards include generally accepted auditing standards (GAAS), generally accepted accounting principles (GAAP), generally accepted government auditing standards (GAGAS), and the standards on auditor independence.

To have its peer review, a CPA firm will engage another CPA firm to perform the review. However, in selecting its peer reviewer, the reviewing CPA firm must be independent of the CPA firm, and must be qualified to perform the review. The Peer Review Committee (the body responsible for evaluating and accepting peer reviews) monitors firm independence and approves the peer review team prior to the peer review taking place.

### Peer Review Reports

There are three types of peer review reports, namely, unmodified, modified, and adverse.

1. An *unmodified report* means the reviewed firm’s system of quality control has been designed to meet the requirements of the quality control standards for an accounting and auditing practice and the system was being complied with during the peer review year to provide the firm with reasonable assurance of complying with professional standards.

2. A *modified report* means the design of the firm's system of quality control created a condition in which the firm did not have reasonable assurance of complying with professional standards or that the firm's degree of compliance with its quality control policies and procedures did not provide it with reasonable assurance of complying with professional standards.
3. An *adverse report* means there are significant deficiencies in the design of the firm's system of quality control, pervasive instances of noncompliance with the system as a whole, or both, resulting in several material failures to adhere to professional standards on engagements.

Typically, unmodified and modified reports are accompanied by a letter of comments. A letter of comments describes matters that the peer reviewer believes resulted in conditions in which there was more than a remote possibility that the firm would not comply with professional standards and sets forth recommendations regarding those matters. A letter of comments is not prepared when an adverse report is issued as all deficiencies, comments, and recommendations are contained in the report itself.

The reviewed firm is required to respond in writing to the peer reviewer's comments on matters in the peer review report and/or in the letter of comments (called the letter of response). The response describes the actions taken or planned with respect to each matter in the report and/or the letter.

We recommend that audit committees request a copy of the auditor's latest peer review report and discuss both the report and the letter of comments with the auditor. If a report is modified or adverse, the audit committee should discuss the reasons as part of its assessment as to whether or not it should engage or continue to engage the auditor.

### **Common Misconceptions of Peer Review**

1. *Fiction:* A peer review evaluates every engagement audited by a CPA firm. *Fact:* A peer review is performed using a risk-based approach. A peer reviewer must review enough engagements to obtain reasonable assurance that the reviewed firm is complying with its quality control policies and procedures. Therefore, it is possible that the review would not disclose all weaknesses in the system of quality control or all instances of lack of compliance with it.
2. *Fiction:* An unmodified report provides assurance with respect to every engagement conducted by the firm. *Fact:* Every engagement conducted by a firm is not included in the scope of a peer review nor is every aspect of each engagement reviewed. The peer review includes reviewing all key areas of engagements selected.
3. *Fiction:* If a firm receives a letter of comments, its system of quality control is inadequate. *Fact:* The criterion for including an item in the letter of comments is whether the item resulted in a condition being created in which there was more than a remote possibility that the firm would not comply with professional standards on accounting and auditing engagements. Because this is a very low threshold, most peer reviews result in the issuance of a letter of comments.

### Questions for the Auditor Regarding Peer Review

The following questions are ones that the audit committee should consider asking its auditors in order to gain a better understanding of the firm's peer review experience.


Question	Yes	No	Comments
1. Is the firm subject to peer review? If not, please explain.	<input type="checkbox"/>	<input type="checkbox"/>	
2. What do the findings and recommendations in the letter of comments mean?			
3. Does the firm's letter of response demonstrate that the firm is committed to making the changes necessary to improve its practice? If not, please explain.	<input type="checkbox"/>	<input type="checkbox"/>	
4. If the peer review report was modified, explain why.			
5. Did the firm correct the deficiencies noted in either the peer review report and/or the letter of comments? If not, please explain.	<input type="checkbox"/>	<input type="checkbox"/>	
6. Did the Peer Review Committee request any follow-up actions? If so, have these actions been completed and accepted by the committee?	<input type="checkbox"/>	<input type="checkbox"/>	
7. Was our company selected for review during the peer review? If so, were any negative responses noted?	<input type="checkbox"/>	<input type="checkbox"/>	
8. Was the engagement partner (and other key engagement team members) selected for review during the peer review? If so, were any negative responses noted on audits performed by them?	<input type="checkbox"/>	<input type="checkbox"/>	

### Public Company Accounting Oversight Board Inspection

The Sarbanes-Oxley Act of 2002 ("Act") established the Public Company Accounting Oversight Board (PCAOB) to oversee the audits of issuers as defined in the Act. The PCAOB is establishing an inspection program that will assess the degree of compliance of each registered public accounting firm and firm personnel with the Act, the rules of the PCAOB, the rules of the SEC, and professional standards, in connection with its performance of audits, issuance of audit reports, and related matters involving issuers as defined in the Act.

All firms required to register with the PCAOB must do so by October 23, 2003. Registered public accounting firms auditing more than 100 issuers will be subject to inspection by the PCAOB on a yearly basis. All other registered firms will be subject to an inspection every three years. The PCAOB will inspect a firm's SEC practice only. The firm's non-SEC practice will be subject to a peer review. The audit committee should monitor PCAOB developments by reviewing the PCAOB Web site at [www.pcaobus.org](http://www.pcaobus.org).

It is expected, as of the date of this publication, that the PCAOB inspection will only focus on the firm's audit practice with respect to SEC registrant organizations. However, it is also expected that firms subject to PCAOB inspection will continue to participate in the AICPA peer review program with respect to their non-SEC registrant audit clients by having a *bridge review*. This information will be updated for any changes through the *Audit Committee Effectiveness Center*, located at [www.aicpa.org/acec](http://www.aicpa.org/acec).



## Internal Control: A Tool for the Audit Committee

**PURPOSE OF THIS TOOL:** Internal control over financial reporting has always been a major area in the governance of an organization, and this importance has been magnified in recent years. This tool is intended to give audit committees basic information about internal control to understand what it is, what it is not, how it can be used most effectively in the organization, and the requirements of management with respect to the system of internal control over financial reporting. Note that the primary responsibility of the audit committee with respect to internal control is the system of internal control over financial reporting.

If the company is subject to the Sarbanes-Oxley Act of 2002 (the Act), it is important that the audit committee be familiar with the final SEC rules on Section 404 of the Act addressing internal control over financial reporting. See “Management’s Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports,” [June 5, 2003, Release Nos. 33-8238; 34-47986]. The final rules are available on the SEC Web site at <http://www.sec.gov/rules/final/33-8238.htm>.

### Internal Control Primer—Basics of Internal Control

In 1992, the Committee of Sponsoring Organizations (COSO)<sup>1</sup> of the National Commission on Fraudulent Financial Reporting (also known as the Treadway Commission) published a document called: *Internal Control—Integrated Framework*,<sup>2</sup> which defined internal control as “a process, effected by an entity’s board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives” in three categories:

1. Effectiveness and efficiency of operations
2. Reliability of financial reporting, and
3. Compliance with applicable laws and regulations

Internal control can be judged as effective in each of these categories if the board of directors and management have reasonable assurance that:

1. They understand the extent to which the entity’s operations objectives are being achieved.
2. Published financial statements are being prepared reliably.
3. Applicable laws and regulations are being complied with.

<sup>1</sup> The Committee of Sponsoring Organizations consists of the American Institute of CPAs (AICPA), the Institute of Management Accountants (IMA), the Institute of Internal Auditors (IIA), Financial Executives International (FEI), and the American Accounting Association (AAA).

<sup>2</sup> The COSO publication *Internal Control—Integrated Framework* (Product Code Number 990012), may be purchased through the AICPA store at [www.cpa2biz.com](http://www.cpa2biz.com). The proceeds from the sale of the Framework are used to support the continuing work of COSO.

The COSO Framework went on to say that internal control consists of five interrelated components as follows:

1. *Control environment.* Sometimes referred to as the “tone at the top” of the organization, meaning the integrity, ethical values and competence of the entity’s people, management’s philosophy and operating style, the way management assigns authority and responsibility, organizes and develops its people, and the attention and direction provided by the board of directors. It is the foundation for all other components of internal control, providing discipline and structure.
2. *Risk assessment.* The identification and analysis of relevant risks to achieve the objectives which form the basis to determine how risks should be managed. This component should address the risks, both internal and external, that must be assessed. Before conducting a risk assessment, objectives must be set and linked at different levels.
3. *Control activities.* Policies and procedures that help ensure that management directives are carried out. Control activities occur throughout the organization at all levels in all functions. These include activities like approvals, authorizations, verifications, reconciliations, reviews of operating performance, security of assets and segregation of duties.
4. *Information and communication.* Addresses the need in the organization to identify, capture and communicate information to the right people to enable them to carry out their responsibilities. Information systems within the organization are key to this element of internal control. Internal information, as well as external events, activities and conditions must be communicated to enable management to make informed business decisions and for external reporting purposes.
5. *Monitoring.* The internal control system must be monitored by management and others in the organization. This is the framework element that is associated with the internal audit function in the company, as well as other means of monitoring such as general management activities and supervisory activities. It is important that internal control deficiencies be reported upstream, and that serious deficiencies be reported to top management and the board of directors.

These five components are linked together, thus forming an integrated system that can react dynamically to changing conditions. The internal control system is intertwined with the organization’s operating activities, and is most effective when controls are built into the organization’s infrastructure becoming part of the very essence of the organization.

Note that while the Sarbanes-Oxley Act of 2002 does specifically mention the COSO Framework, the Act acknowledges that this is not the only Framework that can be used to fulfill management’s requirements about the internal control system. The Act specifically states that other frameworks may be created either within or outside the United States that may satisfy the intent of the statutes. The Act further states certain conditions that must be met in order for a framework to be considered suitable.

An effective internal control structure can actually be part of the competitive advantage of the organization.

## **Key Terms in Internal Control**

There are a few terms that you will hear frequently when discussing internal control, and these are identified and described as follows:

*Reportable condition.* Has the same meaning as the term “significant deficiency.” These two terms are used to define a significant deficiency in the design or operation of internal control that could adversely affect a company’s ability to record, process, summarize and report financial data consistent with the assertions of management in the company’s financial statements. An aggregation of significant deficiencies could constitute a material weakness.

*Material weakness.* Defined in the auditing literature as a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by errors or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned duties.

*Compensating controls.* Some organizations, by virtue of their size, are not able to implement basic controls such as segregation of duties. This apparent lack of control could be overcome through other controls, which could be expected to be more rigorous in this situation than in a situation where the basic control exists. This compensating control could be a permanent part of the control system, or just temporary if a basic control is not able to function for some period of time. See the section of this tool entitled “Compensating Controls” for an example.

*Section 404:* Refers to section 404 of the Sarbanes-Oxley Act of 2002, which requires management to:

1. Make a statement that they are responsible for establishing and maintaining adequate internal control over financial reporting for the company,
2. Make an assessment of the effectiveness of the internal control system as of the company's most recent fiscal year,
3. Identify the framework used by management to evaluate the effectiveness of the internal control system over financial reporting, and
4. Make a statement that the independent auditor has issued an attestation report on management's assessment of the company's internal control over financial reporting.

These requirements are key in the internal control process for SEC registrant companies.

### **What Internal Control Cannot Do**

As important as an internal control structure is to an organization, an effective system is not a guarantee that the organization will be successful. An effective internal control structure will keep the right people informed about the organization's progress (or lack of progress) in achieving its objectives, but it cannot turn a poor manager into a good one. Internal control cannot ensure success, or even survival.

Internal control is not an absolute assurance to management and the board about the organization's achievement of its objectives. It can only provide reasonable assurance, due to limitations inherent in all internal control systems. For example, breakdowns in the internal control structure can occur due to simple error or mistake, as well as faulty judgments that could be made at any level of management. In addition, controls can be circumvented by collusion or by management override. Finally, the design of the internal control system is a function of the resources available, meaning that there must be a cost-benefit analysis in the design of the system.

### **Roles and Responsibilities**

Everyone in the organization has some role to play in the organization's internal control system.

*CEO.* The CEO has ultimate responsibility and “ownership” of the internal control system. The individual in this role sets the tone at the top that affects the integrity and ethics and other factors that create the positive control environment needed for the internal control system to thrive. Aside from setting the tone at the top, much of the day-to-day operation of the control system is delegated to other senior managers in the company, under the leadership of the CEO.



**CFO.** Much of the internal control structure flows through the accounting and finance area of the organization under the leadership of the CFO. In particular, controls over financial reporting fall within the domain of the chief financial officer. The audit committee should use interactions with the CFO, and others, as a basis for their comfort level on the internal control over financial reporting.

This is not intended to suggest that the CFO must provide the audit committee with a level of assurance regarding the system of internal control over financial reporting. Rather, through interactions with the CFO and others, the audit committee should get a “gut feeling” about the completeness, accuracy, validity and maintenance of the system of internal control over financial reporting.

In a public company, the CFO and CEO are required to certify that they (among other things):

1. Are responsible for establishing and maintaining internal controls;
2. Have designed such internal controls to ensure that material information relating to the company and its consolidated subsidiaries is made known to the CFO and CEO by others within those entities, particularly during the period in which the periodic reports are being prepared;
3. Have evaluated the effectiveness of the company's internal controls as of a date within 90 days prior to the report; and
4. Have presented in the report their conclusions about the effectiveness of their internal controls based on their evaluation as of that date;
5. Have disclosed to the company's auditors and the audit committee (a) all significant deficiencies in the design or operation of internal control which could adversely affect the company's ability to record, process, summarize, and report financial data and have identified for the company's auditors any material weaknesses in internal control; and (b) any fraud, whether or not material, that involves management or other employees who have a significant role in the company's internal controls; and
6. Have indicated in their report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Section 404 of the Sarbanes-Oxley Act addresses management assessments of the internal control system of the company. There has been considerable discussion about the role the company's auditors can play in that process, since the auditors must then make their own report on the effectiveness of management's assessment.

The AICPA urges great caution in this area. If the company's auditors are to be involved in management's assessment, it is important to note that management must be in control of the process at all times. An important resource for management and the audit committee when addressing this issue is a speech made by Scott A. Taub, SEC Deputy Chief Accountant, “The SEC's Internal Control Report Rules and Thoughts on the Sarbanes-Oxley Act,” May 29, 2003. You may find this speech on the SEC Web site at: <http://www.sec.gov/news/speech/spch052903sat.htm>

*Controller.* Much of the basics of the control system come under the domain of this position. It is key that the controller understand the need for the internal control system, is committed to the system, and communicates the importance of the system to all people in the accounting organization. Further, the controller must demonstrate respect for the system through his or her actions.

*Internal Audit.* A main role for the internal audit team is to evaluate the effectiveness of the internal control system and contribute to its ongoing effectiveness. With the internal audit team reporting directly to the audit committee of the board of directors and/or the most senior levels of management, it is often this function that plays a significant role in monitoring the internal control system.

*Board of Directors/Audit Committee.* A strong, active board is necessary. This is particularly important when the organization is controlled by an executive or management team with tight reins over the organization and the people within the organization. The board should recognize that its scope of oversight of the internal control system applies to all three major areas of control: over operations, over compliance with laws and regulations, and over financial reporting. The audit committee is the board's first line of defense with respect for the system of internal control over financial reporting.

*All Other Personnel.* The internal control system is only as effective as the employees throughout the organization that must comply with it. Employees throughout the organization should understand their role in internal control and the importance of supporting the system through their own actions and encouraging respect for the system by their colleagues throughout the organization.

## **Compensating Controls**

It is important to realize that both the design and compliance with the internal control system is important. The audit committee should be “tuned-in” to the tone-at-the-top of the organization as a first indicator of the functioning of the internal control system.

In addition, audit committees should realize that the system of internal control should be scaled to the organization. Some organizations will be so small, for example, that they will not be able to have appropriate segregation of duties. The message here is that the lack of segregation of duties is not automatically a material weakness, or even a reportable condition, depending on the compensating controls that are in place.

For example, suppose a company's accounting department is so small that it is not possible to segregate duties between the person that does the accounts payable, and the person that reconciles the bank statements. In this case, it is one and the same person, so the implication is that there are no checks and balances on the accounts payable person, who could be writing checks to a personal account, then passing on them during the bank reconciliation process (that is, there is no one to raise the red flag that personal checks are being written on the company account).

Compensating controls could make up for this apparent breach in the internal control system. Here are some examples of compensating controls in this situation:

1. All checks are hand signed by an officer of the company, rather than using a signature plate that is in the control of the person that prepared the checks.
2. The bank reconciliation may be reviewed by the person's manager.
3. A periodic report of all checks that are cleared at the bank could be prepared by the bank and forwarded to an officer of the company for review.

Audit committees should be aware of situations like this, and be prepared to ask questions and evaluate the answers when an obvious breach in internal control is surfaced.

### **Management Override of Controls**

Another area that an audit committee needs to focus on is the ability of management to override internal controls over financial reporting to perpetrate a fraud. Examples of techniques used by management in overriding internal controls over the financial reporting function include:

- Back dating sales documents to a prior period,
- Making adjusting entries during the financial reporting closing process, or
- Reclassing items improperly between the income statement and the balance sheet.

Some of these override techniques were used in the accounting scandals that led to the passage of the Sarbanes Oxley Act, and have gained substantial notoriety.

An audit committee has the responsibility to help prevent or deter a management override of controls. It is important for the audit committee to understand that there is a system to uncover an override, as well as follow-up to determine its appropriateness. Questions about management override, and the controls over management override, as well as audit steps to detect if a management override has occurred, should be addressed to the CEO, CFO, CAE, and independent auditor during the respective executive sessions with the audit committee as noted elsewhere in this toolkit.

### **Conclusion**

This primer should have given you a sense of what people mean when they refer to *internal control*. The concepts are not complex, but sometimes the application of internal control can be a challenge in an organization, depending on its size and the corporate culture. However, it is vitally important to design the system of internal control to achieve the objectives of: (1) effectiveness and efficiency of operations, (2) reliability of financial reporting, and (3) compliance with applicable laws and regulations.

Simply stated, at the end of the day, a strong system of internal control (both in its design and compliance) is good business.

### **Internal Control—A Tool for the Audit Committee**

The following tool, “Internal Control—A Tool for the Audit Committee,” contains questions modeled on those found in the COSO Report, *Internal Control—Integrated Framework*.

## **Internal Control—A Tool for the Audit Committee**

COSO Framework	Yes	No	Not sure	Comments
<b>Control Environment—Integrity and Ethical Values (cont.)</b>				
<p><b>PURPOSE OF THIS TOOL:</b> This tool focuses on the five interrelated components of an internal control system, as described in the <i>COSO Internal Control—Integrated Framework</i><sup>3</sup> publication. Refer to “Internal Control Primer—Basics of Internal Control,” earlier in this section for a discussion of the COSO components. The audit committee’s role in the internal control structure of the company focuses on internal controls over financial reporting and the various systems (human resources, computing, and other) available to support that process, and this tool is created to facilitate that role. The audit committee needs to be assured that the controls are in place and operating effectively. This can be achieved through the committee’s interaction with senior management, independent auditors, internal auditors, and other key members of the financial management team.</p>				

**INSTRUCTIONS FOR USING THIS TOOL:** This tool is created around the five interrelated components of an internal control structure. Within each component is a series of questions that the audit committee should focus on to assure itself that controls are in place and functioning. These questions should be discussed in an open forum with the individuals that have a basis for responding to the questions. The audit committee should ask for detailed answers and examples from the management team, including key members of the financial management team, internal auditors, and independent auditors to assure itself that the system is operating as management represents. Evaluation of the internal control structure is not a one-time, but rather a continuous event for the audit committee—the audit committee should always have its eyes and ears open for potential weaknesses in internal control, and should continually probe the responsible parties regarding the operation of the system. These questions are written in a manner such that a “No” response indicates a weakness that

COSO Framework	Yes	No	Not sure	Comments
<b>Control Environment—Integrity and Ethical Values</b>				
1. Does the organization have a comprehensive code of conduct, and/or other policies addressing acceptable business practice, conflicts of interest, and expected standards of ethical and moral behavior?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	

<sup>3</sup> The questions in this tool are adapted from “Evaluation Tools,” Volume 2 of the *COSO Internal Control—Integrated Framework* (Product Code Number 990012), published September 1992, by the Committee of Sponsoring Organizations. It may be purchased through the AICPA store at [www.cpa2biz.com](http://www.cpa2biz.com). The proceeds from the sale of the Framework are used to support the continuing work of COSO.

3. Are all employees required to periodically acknowledge that they have read, understood, and complied with the code?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
4. Does management demonstrate through actions its own commitment to the code of conduct?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
5. Are dealings with customers, suppliers, employees, and other parties based on honesty and fair business practices?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
6. Does management take appropriate action in response to violations of the code of conduct?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
7. Is management explicitly prohibited from overriding established controls? What controls are in place to provide reasonable assurance that controls are not overridden by management? Are deviations from this policy investigated and documented? Are violations (if any) and the results of investigations brought to the attention of the audit committee?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
8. Is the organization proactive in reducing fraud opportunities by (1) identifying and measuring fraud risks, (2) taking steps to mitigate identified risks, (3) identifying a position within the organization to “own” the fraud prevention program, and (4) implementing and monitoring appropriate preventative and detective internal controls and other deterrent measures?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
9. Does the company utilize an anonymous ethics and fraud hotline, and, if so, are procedures in place to investigate and report results to the audit committee? (See also the tool “Tracking Report: Anonymous Submission of Suspected Wrongdoing (Whistleblowers)” in this toolkit.)	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	

COSO Framework	Yes	No	Not sure	Comments
<b>Control Environment—Commitment to Competence</b>				
2. Does management make an effort to determine whether the accounting and internal audit organizations have adequate knowledge and skills to do their jobs?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
<b>Control Environment—Board of Directors and/or Audit Committee</b>				
1. Are the audit committee's responsibilities defined in a charter? If so, is the charter updated annually and approved by the board of directors? (See also the tool "Audit Committee Charter Matrix," in this toolkit.)	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
2. Are audit committee members independent of the company and of management? Do audit committee members have the knowledge, industry experience, and financial expertise to serve effectively in their role?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
3. Are a sufficient number of meetings held, and are the meetings of sufficient length and depth to cover the agenda, and provide healthy discussion of issues?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
4. Does the audit committee constructively challenge management's planned decisions, particularly in the area of financial reporting, and probe the evaluation of past results?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
5. Are regular meetings held between the audit committee and the CFO (chief financial officer), the chief audit executive (CAE, the leader of the internal audit team), other key members of the financial management and reporting team, and the independent auditors? Are executive sessions conducted on a regular basis? (See also the tool "Conducting an Audit Committee Executive Session: Guidelines and Questions," in this toolkit.)	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
6. Does the audit committee approve internal audit's annual audit plan?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
Does the audit committee approve internal audit's annual audit plan?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	

COSO Framework	Yes	No	Not sure	Comments
<b>Control Environment—Board of Directors and/or Audit Committee (cont.)</b>				

**The AICPA Audit Committee Toolkit**

7. Does the audit committee receive key information from management in sufficient time in advance of meetings to prepare for discussions at the meetings?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
8. Does a process exist for informing audit committee members about significant issues on a timely basis and in a manner conducive to the audit committee having a full understanding of the issues and their implications? (See also the tool "Issues Report From Management," in this toolkit.)	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
9. Is the audit committee informed about personnel turnover in key functions including the audit team (both internal and the independent auditors), senior executives, and key personnel in the financial accounting and reporting teams? Are unusual employee turnover situations observed for patterns or other indicators of problems?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
<b>Control Environment—Management's Philosophy and Operating Style</b>				
1. Is the accounting function viewed as a team of competent professionals bringing information, order, and controls to decision-making?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
2. Is the selection of accounting principles made in the long-term best interest of the organization (as opposed to short-term maximization of income)?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
3. Are valuable assets, including intellectual assets, protected from unauthorized access and use?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
4. Do managers respond appropriately to unfavorable signals and reports?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
5. Are estimates and budgets reasonable and achievable?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	

COSO Framework	Yes	No	Not sure	Comments
<b>Control Environment—Organizational Structure</b>				
1. Is the organizational structure within the accounting function and the internal audit function appropriate for the size of the organization?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	

2. Are key managers in the accounting and internal audit functions given adequate definition of their responsibilities?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
3. Do sufficient numbers of employees exist, particularly at the management levels in the accounting and internal audit functions to allow those individuals to effectively carry out their responsibilities?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
<b>Control Environment—Assignment of Authority and Responsibility</b>				
1. Is the authority delegated appropriate for the responsibilities assigned?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
2. Are job descriptions in place for management and supervisory personnel in the accounting and internal audit functions?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
3. Do senior managers get involved as needed to provide direction, address issues, correct problems and/or implement improvements?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
<b>Control Environment—Human Resources Policies and Practices</b>				
1. Are policies and procedures in place for hiring, training, promoting, and compensating employees in the accounting and internal audit functions?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
2. Do employees understand that sub-standard performance will result in remedial action?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
3. Is remedial or corrective action taken in response to departures from approved policies?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
4. Do employees understand the performance criteria necessary for promotions and salary increases?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	

COSO Framework	Yes	No	Not sure	Comments
<b>Risk Assessment</b>				
1. Does the organization consider risks from external sources such as creditor demands, economic conditions, regulation, labor relations (e.g., unions), etc.?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	



2. Does the organization consider risks from internal sources such as key employees (retention and succession planning), financing and the availability of funding for key programs, competitive compensation and benefits, information systems security and backup systems?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
3. Is the risk of a misstatement of the financial statements considered and are steps taken to mitigate that risk?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
4. If applicable, are the risks associated with foreign/off-shore operations considered, including their impact on the financial reporting process?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
<b>Control Activities</b>				
1. Does the organization have a process in place to ensure that controls as described in its policy and procedures manuals are applied as they are meant to be applied? Do the policy and procedures manuals document all important policies and procedures? Are these policies and procedures reviewed and updated on a regular basis? If so, by whom?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
2. Do supervisory personnel review the functioning of controls? If so, how is that review conducted and what happens to the results? Is appropriate and timely follow-up action taken on exceptions?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
<b>Information and Communication</b>				
1. Is a process in place to collect information from external sources, such as industry, economic, and regulatory information that could have an impact on the business and/or the financial reporting process?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	

COSO Framework	Yes	No	Not sure	Comments
<b>Information and Communication</b> (cont.)				
2. Are milestones to achieve financial reporting objectives monitored to ensure that timing deadlines are met?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	

3. Is necessary operational and financial information communicated to the right people in the organization on a timely basis and in a format that facilitates its use, including new or changed policies and procedures?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
4. Is a process in place to respond to new information needs in the organization on a timely basis?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
5. Is there a process in place to collect and document errors or complaints to analyze, determine cause, and eliminate a problem from recurring in the future?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
6. Is a process established and communicated to officers, employees, and others, about how to communicate suspected instances of wrongdoing by the company or employees of the company? Further, does a process exist to ensure that anyone making such a report is protected from retaliation for making such a report? (See also the tool entitled "Tracking Report: Anonymous Submission of Suspected Wrongdoing (Whistleblowers)" elsewhere in this toolkit.)	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	

### Monitoring

1. Do officers and employees understand their obligation to communicate observed weaknesses in design or compliance with the internal control structure of the organization to the appropriate supervisory or management personnel?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
2. Are interactions with external stakeholders periodically evaluated to determine if they are indicative of a weakness in the internal controls structure? (For example, consider the frequency of customer complaints about incorrect bills.)	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	

COSO Framework	Yes	No	Not sure	Comments
<b>Monitoring</b> (cont.)				

4. Are personnel asked to periodically state whether they understand and comply with the organization's code of conduct?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
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3. Is there follow-up on recommendations from the internal and external auditors for improvements to the internal control system?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
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5. Are personnel required to sign off, indicating their performance of critical control activities such as performing reconciliations?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
6. Does the internal audit team have the right number of competent and experienced staff? Do they have access to the board of directors and audit committee? Is the reporting structure in place to ensure their objectivity and independence? Is the work of the internal audit team appropriate to the organization's needs, and prioritized with the audit committee's direction?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	



## Fraud and the Responsibilities of the Audit Committee: An Overview

**PURPOSE OF THIS TOOL:** An audit committee should take an active role in the prevention and deterrence of fraud, as well as an effective ethics and compliance program. The audit committee should constantly challenge management and the auditors to ensure that the entity has appropriate antifraud programs and controls in place to identify potential fraud and ensuring that investigations are undertaken if fraud is detected. The audit committee should take an interest in ensuring that appropriate action is taken against known perpetrators of fraud.

This tool is intended to make audit committee members aware of their responsibilities as they undertake this important role. This tool highlights areas of corporate activity that may require additional scrutiny by the audit committee.




Prominent news reports have indicated that significant corporate fraud has continued even after the passage of the Sarbanes-Oxley Act of 2002. The public's expectations have been raised about all parties involved in organizational governance, including the audit committee, management, independent auditors, internal auditors, regulators, and law enforcement. The audit committee's role in the United States has been greatly elevated as a result of such fraud discoveries and by recent legislation and new stock exchange requirements.

### Definition and Categories of Fraud

An understanding of fraud is essential for the audit committee to carry out its responsibilities. The term *fraud* is defined in *Black's Law Dictionary* (Sixth Edition, 1990) as:

An intentional perversion of truth for the purpose of inducing another in reliance upon it to part with some valuable thing belonging to him or to surrender a legal right. A false representation of a matter of fact, whether by words or by conduct, by false or misleading allegations, or by concealment of that which should have been disclosed, which deceives and is intended to deceive another so that he shall act upon it to his legal injury. . . . A generic term, embracing all multifarious means which human ingenuity can devise, and which are resorted to by one individual to get advantage over another by false suggestions or by suppression of truth, and includes all surprise, trick, cunning, dissembling, and any unfair way by which another is cheated.

The audit committee also needs to be aware that fraud affecting the organization often falls within one of three categories:

-  *Management fraud*, which involves senior management's intentional misrepresentation of financial statements, or theft or improper use of company resources.
-  *Employee fraud*, which involves nonsenior employee theft or improper use of company resources.
-  *External fraud*, which involves theft or improper use of resources by people who are neither management nor employees of the firm.

This categorization of fraud is useful, but not absolute. Middle management employees may intentionally misrepresent financial statement transactions, for example, to improve their apparent performance, or outside individuals may collude with company management or employees.

### **Roles of the Audit Committee in the Prevention, Deterrence, Investigation, and Discovery or Detection of Fraud**

The members of the audit committee should understand their role of ensuring that the organization has antifraud programs and controls in place to help prevent fraud, and aid in its discovery if it does occur, to properly fulfill their fiduciary duties of:

1. Monitoring the financial reporting process
2. Overseeing the internal control system
3. Overseeing the internal audit and independent public accounting functions, and
4. Reporting findings to the board of directors.

Guidance to boards of directors, audit committees, and management to help prevent, deter, and detect fraud is contained in the AICPA's *Antifraud & Corporate Responsibility Resource Center* available at [www.aicpa.org/antifraud/homepage.htm](http://www.aicpa.org/antifraud/homepage.htm). The information contained in the center can be viewed from different user perspectives for a personalized focus on the issues.

The specific requirements for audit committees, as outlined in Sarbanes-Oxley and the Securities and Exchange Commission (SEC) rules are provided in the AICPA's *Sarbanes-Oxley/PCAOB Implementation* Web site. (PCAOB stands for the Public Company Accounting Oversight Board, a private, nonprofit company created by the Sarbanes-Oxley Act of 2002.) The AICPA has created a *Sarbanes-Oxley/PCAOB Implementation Central* resource section on its Web site, available at [www.aicpa.org/sarbanes/index.asp](http://www.aicpa.org/sarbanes/index.asp).

The audit committee should ensure that the organization has implemented an effective ethics and compliance program, and that it is periodically tested. Since the occurrence of significant frauds can frequently be attributed to an override of internal controls, the audit committee plays an important role to ensure that internal controls address the appropriate risk areas and are functioning as designed.

Internal auditors and external auditors can serve a vital role in aiding in fraud prevention and deterrence. Internal audit staff and external auditors who are experienced and trained in fraud prevention and deterrence can help to provide assurance that (1) risks are effectively identified and monitored; (2) organizational processes are effectively controlled and tested periodically; and (3) appropriate follow-up action is taken to address control weaknesses. The audit committee needs to ensure that internal and external auditors are carrying out their responsibilities in connection with potential fraud.

### **Expertise of Forensic Accounting Consultants**

In some situations, it may be necessary for an organization to look beyond the independent audit team for expertise in the fraud area. In such cases, CPA forensic accounting consultants can provide additional assurance or advanced expertise, since they have special training and experience in fraud prevention, deterrence, investigation, and detection. Forensic accounting consultants may also provide fresh insights into the organization's operations, control systems, and risks. The work of forensic accounting consultants may also provide comfort for the organization's CEO and CFO, who are required to file certifications under Sarbanes-Oxley. Forensic accounting consultants, however, cannot act as an insurer to prevent or detect fraud.

## **When Fraud Is Discovered**

Fraud can be discovered through many sources, namely, internal or external auditors, forensic accounting consultants, employees, vendors, and others. Establishing a confidential hotline can also be an important source of information leading to fraud discovery, as part of an organization's overall ethics, compliance, and fraud prevention program. Although a confidential hotline is something that could be accomplished internally, there are a variety of outside service providers that can be engaged to provide this service for the company.

If fraud or improprieties are asserted or discovered, the audit committee—through the external auditors, internal auditors, or forensic accounting consultants, as appropriate—should investigate, and, if necessary, retain legal counsel to assert claims on the organization's behalf. Forensic accounting consultants, in particular, may be needed to provide the depth of skills necessary to conduct a fraud investigation, and if it is desirable to get an independent assessment.

If fraud is discovered, or there is a reasonable basis to believe that fraud may have occurred, the audit committee is responsible for ensuring that an investigation is undertaken. Criteria should be in place describing the audit committee's level of involvement, based on the severity of the offense. Most audit committees will also want to obtain information about all violations of the law and the organization's policies.

Forensic accounting consultants can also frequently provide audit committees with other related advisory services, namely, (1) evaluations of controls designs and operating effectiveness through compliance verification; (2) creation of special investigations units (SIUs); (3) incident management committees; (4) disclosure risk controls; (5) ethics hotlines; (6) code of conduct; and other antifraud measures.

Under SEC rules clarifications (January 29, 2003), the audit committee can engage the audit firm to carry out a forensic/fraud investigation. It's important to recognize, however, that the audit firm would be precluded from subsequently serving as an expert witness in such circumstances. Forensic professionals that are not affiliated with the audit firm would not be subject to such constraints. In addition, if CPA forensic accountants are engaged by the corporate office of general counsel, rather than the audit committee, they may potentially attain attorney-client privilege status, not otherwise available under normal circumstances.

## **Whistleblowers**

The Sarbanes-Oxley Act of 2002 requires companies to establish procedures for the receipt, retention, and treatment of complaints received by the issuer regarding accounting, internal accounting controls, or auditing matters; and the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters (see Sarbanes-Oxley Act of 2002, Title III, Section 301.) See also the tool "Tracking Report: Anonymous Submission of Suspected Wrongdoing (Whistleblowers)" elsewhere in this toolkit.

## **Conclusion**

The demands of the investing public, U.S. corporations, and the regulatory environment have focused attention on the increased need to fight fraud. The public is demanding greater vigilance from all parties involved in organizational governance. Audit committees are required to play a pivotal role in the prevention and deterrence of fraud, and to take appropriate action in the discovery of fraud. Independent public accountants, hired by audit committees, and internal auditors will continue to play an important part in the process. CPA forensic accounting consultants have emerged, however, as vital newly recognized allies. Qualified forensic accounting consultants have the education, training, and experience to provide additional assistance to audit committees so that they may better carry out their fiduciary responsibilities in the fight against fraud.



## Management's Summary of Off-Balance-Sheet Transactions

**PURPOSE OF THIS TOOL:** An area that has come under scrutiny, and one where the company may be at risk, is off-balance-sheet transactions. Generally accepted accounting principles (GAAP) permit certain kinds of transactions to be accounted for off the company's balance sheet, and many companies, as a means of managing risk and/or taking advantage of legitimate tax minimization opportunities, create off-balance-sheet transactions. It is important that the audit committee understand the nature and the reason for each off-balance-sheet item, and ensure that any such relationships are adequately disclosed. This tool is intended to assist audit committee members in gaining an understanding of management's use of off-balance-sheet transactions so they may weigh in on the appropriateness of the treatment and whether it will meet regulatory requirements.

An area that has come under scrutiny, and one in which the company may be at risk, is off-balance-sheet transactions. The audit committee should be aware of transactions and circumstances that may require recognition on the balance sheet and should ensure that those transactions and events have been accounted for properly. Furthermore, the audit committee should ensure that, in addition to fulfilling the disclosure requirements of GAAP, the Management's Discussion & Analysis (MD&A) disclosure requirements have been met with respect to any transaction, or any agreement or contractual arrangement, with an unconsolidated entity under which the company has or in the future may have:

1. Any obligation under a direct or indirect guarantee or similar arrangement;
2. A retained or contingent interest in assets transferred to an unconsolidated entity or similar arrangement;
3. Derivatives, to the extent that the fair value thereof is not fully reflected as a liability or asset in the financial statements; or
4. Any obligation or liability, including a contingent obligation or liability, to the extent that it is not fully reflected on the face of the financial statements.

It is imperative that the audit committee have a healthy and continuing dialogue with management about off-balance-sheet items. In doing so, following are some questions that should be regularly asked of management:

Audit Committee Questions of Management	Notes
1. Please describe the company's process for identifying variable interest entities that might require consolidation in accordance with Financial Accounting Standards Board (FASB) Interpretation No. 46 <i>Consolidation of Variable Interest Entities</i> . (A summary of FIN 46 follows.)	
2. Are there any entities that would be consolidated as variable interest entities if different subjective determinations had been made in applying FASB Interpretation No. 46? If so, please provide details.	
3. Please describe the company's process for identifying and valuing direct or indirect guarantees in accordance with FASB Interpretation No. 45, <i>Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others</i> . (A summary of FIN 45 follows.)	
4. Please describe how any recognized guarantee liabilities, including related charges, have been accounted for and how they will be accounted for in the future.	



**Management's Summary of Off-Balance-Sheet Transactions**

Audit Committee Questions of Management	Notes
5. Has the company entered into any related transactions that, when viewed individually, do not result in the recognition of a liability but that, if viewed together, might be deemed to result in a liability or obligation? If so, please provide details.	
6. Has the company solicited or received advice from or given advice to any outside party on how to structure any transaction to produce a desired financial statement effect? If so, please provide details.	

## **Summary of FASB Interpretation No. 46**

FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*, an Interpretation of Accounting Research Bulletin No. 51, *Consolidated Financial Statements*, addresses consolidation by business enterprises of variable interest entities\*, which have one or both of the following characteristics:

1. The equity investment at risk is not sufficient to permit the entity to finance its activities without additional subordinated financial support from other parties, which is provided through other interests that will absorb some or all of the expected losses of the entity.
2. The equity investors lack one or more of the following essential characteristics of a controlling financial interest:
  - a. The direct or indirect ability to make decisions about the entity's activities through voting rights or similar rights
  - b. The obligation to absorb expected losses of the entity if they occur, which makes it possible for the entity to finance its activities
  - c. The right to receive the expected residual returns of the entity if they occur, which is the compensation for the risk of absorbing the expected losses

The following are exceptions to the scope of this Interpretation:

1. Not-for-profit organizations are not subject to this Interpretation unless they are used by business enterprises in an attempt to circumvent the provisions of this Interpretation.
2. Employee benefit plans subject to specific accounting requirements in existing FASB Statements are not subject to this Interpretation.
3. Registered investment companies are not required to consolidate a variable interest entity unless the variable interest entity is a registered investment company.
4. Transferors to qualifying special-purpose entities and "grandfathered" qualifying special-purpose entities subject to the reporting requirements of FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, do not consolidate those entities.
5. No other enterprise consolidates a qualifying special-purpose entity (SPE) or a "grandfathered" qualifying SPE unless the enterprise has the unilateral ability to cause the entity to liquidate or to change the entity in such a way that it no longer meets the requirements to be a qualifying SPE or "grandfathered" qualifying SPE.
6. Separate accounts of life insurance enterprises as described in AICPA Auditing and Accounting Guide *Life and Health Insurance Entities*, are not subject to this Interpretation.

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\* The Exposure Draft that preceded this Interpretation referred to the entities subject to its requirements as special-purpose entities (SPEs). Because some entities that have been commonly referred to as SPEs may not be subject to this Interpretation, and other entities that have not commonly been referred to as SPEs may be subject to this Interpretation, the Financial Accounting Standards Board decided to use the term *variable interest entity*.

## **Summary of FASB Interpretation No. 45**

FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*, elaborates on the disclosures to be made by a guarantor in its interim and annual financial statements about its obligations under certain guarantees that it has issued. It also clarifies that a guarantor is required to recognize, at the inception of a guarantee, a liability for the fair value of the obligation undertaken in issuing the guarantee. This Interpretation does not prescribe a specific approach for subsequently measuring the guarantor's recognized liability over the term of the related guarantee. This Interpretation also incorporates, without change, the guidance in FASB Interpretation No. 34, *Disclosure of Indirect Guarantees of Indebtedness of Others*, which is being superseded.

This Interpretation does not apply to certain guarantee contracts, guarantees issued by insurance and reinsurance companies and accounted for under accounting principles for those companies; residual value guarantees provided by lessees in capital leases, contingent rents, vendor rebates and guarantees whose existence prevents the guarantor from recognizing a sale or the earnings from a sale. Furthermore, the provisions related to recognizing a liability at inception for the fair value of the guarantor's obligation do not apply to the following:

- a. Product warranties
- b. Guarantees that are accounted for as derivatives
- c. Guarantees that represent contingent consideration in a business combination
- d. Guarantees for which the guarantor's obligations would be reported as an equity item (rather than a liability)
- e. An original lessee's guarantee of lease payments when that lessee remains secondarily liable in conjunction with being relieved from being the primary obligor (that is, the principal debtor) under a lease restructuring
- f. Guarantees issued between either parents and their subsidiaries or corporations under common control
- g. A parent's guarantee of a subsidiary's debt to a third party, and a subsidiary's guarantee of the debt owed to a third party by either its parent or another subsidiary of that parent

However, the guarantees described in items a to g above are subject to the disclosure requirements of this Interpretation.



## Issues Report From Management

**PURPOSE OF THIS TOOL:** This tool is to be used by management when considering significant issues, estimates, and judgments that may have a material impact on the company's financial statements, among other concerns. Management should be encouraged to use this tool as a means to document any significant issues, judgments, and estimates for discussion with the audit committee. Each matter should be prepared as a separate issues report. Statements should be clear and concise. Some issues may carry over to subsequent meetings, in which case, any updated information should be included in bold.

### Defining Significant Issues, Estimates, and Judgments

As a first step to any discussion of this nature, it is important for the audit committee to define its threshold for a significant issue, judgment and estimate. Following are some points that the audit committee should consider in its quest to define a significant issue, estimate, or judgment.

A significant issue, estimate, or judgment is one that:

1. Creates controversy among members of the management team, or between management and the internal or independent auditors.
2. Has or will have a material impact on the financial statements.
3. Is or will be a matter of public interest or exposure.
4. Must be reported in an upcoming filing with an external body and management is unclear or undecided on its presentation.
5. Applies a new accounting standard. (Note that the application of a new accounting standard may or may not be considered a significant issue, estimate, or judgment for the organization. However, for the record, the audit committee may ask management to use this format as a means to brief the audit committee on the application of the new standard.)
6. Relates to the application of a standard in a way that is not consistent with general practice.
7. Relates to key controls over financial information that are being designed, redesigned, have failed, or otherwise are being addressed by the organization.

The audit committee needs to be proactive and consistent in its inquiries regarding significant issues, estimates, and judgments. At each meeting, the audit committee should inquire about current and/or unresolved issues or problems that have arisen in the financial, compliance, or operational control environment. Management's response should be documented in the meeting minutes.

Management's report to the audit committee concerning significant issues, estimates, and judgments should contain the following elements for a proper basis of discussion by the audit committee:

1. *Definition of the Significant Issue, Estimate, or Judgment.* In this section of the issues report, management should define and summarize the issue as concisely and clearly as possible.
2. *Management's Position.* This section should address management's position on the issue. If there is disagreement among members of management, those disagreements should be identified here as explicitly as possible, with brief explanations of why each member of the management team has taken their respective position.
3. *Relevant Literature.* Any professional literature or regulatory requirements addressing this issue should be cited here. If no professional literature is available, it would be appropriate to define industry practice in this space. If this is a developing area, and there is neither accepted industry practice nor other sources to support and refute these positions, this fact should be reported. If there was a choice on the accounting treatment, it should be disclosed here along with a discussion of how the choices of treatment were compared and the basis on which the final choice was made.
4. *Risks.* Management should identify various risks (both good and bad) associated with this proposal.
5. *Securities and Exchange Commission or Other Regulatory Disclosure.* Management must inform the audit committee about how it intends to address this issue in required filings with the Securities and Exchange Commission (SEC) or other regulatory bodies as required by law.
6. *Auditor's Position.* Has management consulted with the independent auditors on this issue? Do they agree with management's position? Have they addressed the audit issues that might be associated with it? If so, use this section of the issues report to discuss their position. If not, use this section to explicitly state that the auditors have not been consulted.
7. *Other Information Relating to This Issue, Estimate, or Judgment.* Management should use this section of the issues report to highlight other related and relevant information that is not already included in the sections above.

## Sample Issues Report From Management

1. Define the Significant Issue, Estimate, or Judgment. Management has received inquiries from the Securities and Exchange Commission (SEC) regarding the valuation of in-process research & development (IPR&D), specifically asking for more detailed accounting information regarding the valuations used in a recent acquisition. The valuation was done by independent appraisers; however, some of the costs may have current value to the company. Specifically, \$10 million in costs should enhance some of the company's current product lines and have future worth to the company. In addition, another \$30 million may also be considered future value.
2. Management's Position. The company has used acquisitions to further their strategic goals to grow the company and achieve an earnings level that will impress Wall Street. In doing so, the company has sought to include much of the purchase price as purchased research, which, consistent with internally developed research, is expensed as it occurs.
3. Relevant Literature. The SEC cites Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 2, *Accounting for Research and Development Costs*, and FASB Interpretation No. 4, *Applicability of FASB Statement No. 2 to Business Combinations Accounted for by the Purchase Method*. The SEC has reservations about acquisition valuations if the amount charged to IPR&D is a significant percentage of the acquisition price.
4. Risks. Recent investigations seem to indicate that SEC investigators are holding companies to a higher threshold in classifying IPR&D amounts than in previous years. In addition, SEC staff are concerned about the dual impact of other accounting issues, such as restructuring charges, and the possible impact of these issues on a company's reported earnings and earnings trends.

At this point, we have a letter of inquiry from the SEC, although no investigation is open; it is a private matter. However, the SEC could choose to make this an investigation, which could mean unwanted publicity. An investigation may result in a required restatement of financial statements, which could jeopardize talks with any future merger or acquisition candidates, and hinder our future growth.

5. SEC Disclosure or Other Regulatory Disclosure. This issue is not applicable at this point in the discussion.
6. Auditor's Position. The auditors have not been consulted on this issue yet. However, they did certify the previous year's financial statements, which included the valuation, and they audited the transaction in question. At the time, they did not raise any issues about the valuation beyond routine discussions with management.
7. Other Information Relating to This Issue, Estimate, or Judgment. IPR&D is the value assigned in a purchase business combination to research projects of the acquired business that have commenced but are not yet completed at the acquisition date and have no alternative future use. The calculations are based on income or cashflow methods and include estimates of operating earnings, capital charges, trade name royalties, etc. The IPR&D calculation for the acquired company in question is \$105 million, allocated to a variety of specific projects that are expected to be completed over the next two to eight years at an estimated additional cost of \$95 million.

Additional information has been collected from the product research staff. Management believes that the company's experience with research, and its past successes bringing R&D efforts to market, will help the company's situation with the SEC. The independent organization that conducted the valuation has been used previously and their results are rarely questioned.

## Issues Report From Management

1. Define the Significant Issue, Estimate, or Judgment.
2. Management's Position.
3. Relevant Literature.
4. Risks.
5. SEC Disclosure (or other regulatory disclosure).
6. Auditor's Position.
7. Other Information relating to this issue, estimate, or judgment.



## Discussions to Expect From the Independent Auditor

**PURPOSE OF THIS TOOL:** Auditing standards\* issued by the AICPA require that the auditor communicate, either orally or in writing, certain information to an audit committee of the board, or another designated party that performs oversight of the financial reporting process.

Communications with audit committees have now engendered more legal and regulatory scrutiny. Independent auditors, in the wake of well-documented business failures and new regulatory oversight, are required to increase their documentation and communication efforts as they relate to their interactions with the audit committee. The following sections list matters that must be communicated. This list is not meant to indicate that this is all that the auditor is communicating to the audit committee, only the minimum *required* communication.

### Auditor's Responsibility Under Generally Accepted Auditing Standards

It is important for audit committees to understand what an audit is and what it is not. Usually, audit committees are most concerned about the system of internal control and that the financial statements are free of material misstatement. The auditor should make sure the audit committee understands the level of responsibility that the auditor assumes for the system of internal control and the financial statements under generally accepted auditing standards (GAAS). It is also important that the auditor make sure that the audit committee understands that an audit is designed to obtain reasonable rather than absolute assurance about the financial statements.

### Significant Accounting Policies

The auditor should determine that the audit committee is informed about all significant accounting policies and how they are applied in the company. To make sure, the audit committee should expect that the auditors will communicate the following:

1. All significant accounting policies, including those that applied for the first time during the year
2. How those accounting policies are applied in the organization
3. Methods the organization used to account for significant unusual transactions
4. The effect of significant accounting policies in controversial or emerging areas for which there is lack of authoritative guidance or consensus (e.g., revenue recognition, off-balance-sheet financing, accounting for equity investments)

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\* It is important to note that the Public Company Accounting Oversight Board (PCAOB) will issue its own standards for audits of public companies, and the audit committee of a public company should keep itself informed of any changes, or new standards that may be issued. (Note that the PCAOB stated that it will adopt the AICPA Audit Standards as interim standards until it issues its own standards for the audit of public companies.) This guidance is based on Statements on Auditing Standards (SAS) No. 61, *Communication With Audit Committees*, as amended, No. 60, *Communication of Internal Control Related Matters Noted in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325), and No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317), and amendments thereto, which are in effect as of this writing.



## **Management Judgments and Accounting Estimates**

Accounting estimates are an integral part of the financial statements prepared by management. These estimates are based on management's judgments (which are normally based on management's knowledge and experience about past and current events), and assumptions about future events.

The auditor should address the following issues with the audit committee:

1. The process used by management in formulating particularly sensitive accounting estimates
2. The basis for the auditor's conclusion about the reasonableness of those estimates

## **Audit Adjustments**

The auditor should inform the audit committee about all audit adjustments arising from the audit that could, in the auditor's judgment, have a significant effect on the entity's financial reporting process. The audit team will keep track of those proposed adjustments for later discussion with management. Management will evaluate those proposed adjustments and decide whether or not the adjustment should be booked to the account balances as proposed. But bear in mind that the auditor may find it necessary to qualify the audit report if management does not record the adjustments that the auditor deems necessary to record.

As part of its communications, the auditor should:

1. Inform the audit committee about adjustments arising from the audit that could either individually or in the aggregate have a significant effect on the organization's financial reporting process.
2. Address whether or not the adjustments were recorded.
3. Determine whether the adjustments may not have been detected except through the auditing procedures performed (meaning that the organization's own internal control system did not detect the need for the adjustment).
4. Explain about uncorrected misstatements aggregated by the auditor during the current engagement and pertaining to the most recent period presented in the financial statements, that were determined by management to be immaterial, both individually and in the aggregate, to the financial statements taken as a whole.

## **Auditor's Judgments About the Quality of Entity's Accounting Principles**

*Note:* This communication is required for audits of public companies. It is not required for organizations that are not public companies, but could be considered a good practice.

Although objective criteria for evaluating the quality of an organization's accounting practices have not been established, the auditor's judgments about the quality, not just the acceptability of the organization's accounting principles as applied in its financial statements, including disclosures, should be discussed. The discussion should be open and frank, and tailored to the organization's specific circumstances. It should include the following topics:

1. Consistency of the organization's accounting principles and their application
2. Clarity of the financial statements and related disclosures
3. Completeness of the financial statements and related disclosures

4. Any items that have a significant impact on the representational faithfulness, verifiability, and neutrality of the accounting information included in the financial statements, examples of which follow:
  - a. Selection of new accounting policies or changes to current ones
  - b. Estimates, judgments, and uncertainties
  - c. Unusual transactions
  - d. Accounting policies relating to significant financial statement items, including the timing of transactions and the period in which they are recorded
5. A discussion of accounting practices that are not specifically addressed in the accounting literature, for example, those that may be unique to a specific industry.

### **Other Information Contained in Audited Financial Statements**

Although the notes to the financial statements are an integral part of the financial statements and therefore are included in the scope of the auditing procedures, other information prepared by management that generally accompanies financial statements is not necessarily included in the scope of the auditing procedures, for example, "Management's Discussion and Analysis of the Financial Condition and Results of Operations."

The auditor should discuss the responsibility, if any, that he or she has for other information in documents containing audited financial statements, any procedures performed and the results.

### **Disagreements With Management**

Disagreements may arise between the auditor and management over the application of accounting principles to specific transactions and events, as well as the basis for management's judgments about accounting estimates, or even the scope of the audit or disclosures to be made in the financial statements or footnotes. Differences of opinion based on incomplete facts or preliminary information that are later resolved are not considered disagreements for this purpose.

When meeting with the audit committee, the auditors should discuss any disagreements with management, whether or not resolved, about matters that individually or in the aggregate could be significant to the organization's financial statements or the auditor's report.

### **Consultation With Other Accountants**

Sometimes, management of the company may consult with other accountants about accounting and auditing matters. If the auditor is aware that such consultation has occurred, the auditor should discuss with the audit committee their views about the significant matters that were the subject of the consultation. The audit committee may wish to ask management whether they have consulted with other accountants about accounting and auditing matters.

### **Major Issues Discussed With Management Prior to Retention**

The auditor should discuss with the audit committee any major issues that were discussed with management in connection with the initial or recurring retention of the auditor. This includes any discussions regarding the application of accounting principles or auditing standards.

## **Difficulties Encountered in Performing the Audit**

The auditor should inform the audit committee about any serious difficulties encountered in working with management during the audit. Examples include, but are not limited to:

1. Unreasonable delays by management in allowing the commencement of the audit
2. Unreasonable delays by management in providing needed information to the auditor
3. Unreasonable timetable set by management for the conduct of the audit
4. Unavailability of client personnel
5. Failure of client personnel to complete client-prepared schedules on a timely basis

## **Illegal Acts**

The auditor has the responsibility to assure himself or herself that the audit committee is adequately informed about illegal acts that come to the auditor's attention (this communication need not include matters that are clearly inconsequential). The communication should describe (1) the act, (2) the circumstances of its occurrence, and (3) the effect on the financial statements.

What is an illegal act for purposes of this communication? Statement on Auditing Standards (SAS) No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317), defines it as: violations of laws or government regulations attributable to the entity, or acts by management or employees on behalf of the entity. Illegal acts do not include personal misconduct by the entity's personnel unrelated to their business activities.

## **Internal Control Matters**

See also the tool, "Internal Control: A Tool for the Audit Committee," in this toolkit.

SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325), requires the auditor to communicate matters relating to the organization's internal control that are observed by the auditor in the conduct of a financial statement audit. These matters should be discussed with the audit committee because they represent significant deficiencies in the design or operation of the internal control system, which could adversely affect the organization's ability to initiate, record, process, and report financial data consistent with the assertions of management in the financial statements.

## **Fraud**

See also the tool, "Fraud and the Responsibilities of the Audit Committee: An Overview" in this toolkit.

SAS No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), requires that the independent auditor bring any evidence of fraud to the attention of the appropriate level of management (generally seen as one level higher than the level at which a suspected fraud may have occurred), even in the case of an inconsequential fraud, such as a minor defalcation by a low-level employee. The independent auditor should reach an understanding with the audit committee regarding when (nature and scope) an inconsequential fraud conducted by a low-level employee should be brought to the audit committee's attention. (See the "Special Note on Illegal Acts for Publicly Traded Companies" that follows.)

Fraud involving senior management, and any fraud (whether caused by senior management or other employees) that causes a material misstatement of the financial statements must be reported to the audit committee by the independent auditor.

### **Special Note for Publicly-Traded Companies Regarding Illegal Acts**

Section 10A of the Securities and Exchange Act of 1934 put certain requirements on auditors, management, and boards of directors when an illegal act has occurred.

As discussed above, if the independent auditor detects evidence of fraud in the organization, the independent auditor must (1) determine whether it is likely that an illegal act has occurred, (2) determine the possible effect of the illegal act on the issuer's financial statements, and (3) promptly inform the appropriate level of management of the illegal act. Section 10A goes one step further than GAAS by requiring that the independent auditor notify the company's management and board of directors as soon as practicable.

After determining that the board of directors has been adequately informed of the detected illegal act, the auditor reaches the following three specified conclusions and must report those conclusions directly to the board of directors as soon as practicable. Those conclusions are:

1. The illegal act would have a material effect on the issuer's financial statements.
2. Senior management has not taken, and the board has not required it to take, timely and appropriate remedial actions with respect to the illegal act.
3. The failure to take remedial action may warrant a departure from the standard audit report or the auditor's resignation.

After receiving notification of the auditor's conclusions, the board of directors has one business day to notify the SEC that it has received such a report. If the auditor does not receive a copy of the board's notification to the SEC within that one business day, the auditor is required to send to the SEC, by the end of the next business day, a copy of the report or documentation of any oral report. In such circumstance, the auditor's resignation from the audit engagement does not negate the auditor's obligation to furnish his or her report to the SEC.



## Tracking Report:\* Anonymous Submission of Suspected Wrongdoing (Whistleblowers)

**PURPOSE OF THIS TOOL:** Audit committees of public companies are required by the Sarbanes-Oxley Act of 2002 to review any complaints received by the company, whether generated internally or externally, regarding internal accounting controls or auditing matters. This tool could be used by the audit committee and management to track complaints received to an appropriate resolution.

### Reasons for Tool

The Sarbanes-Oxley Act of 2002 (the Act) includes a number of provisions that directly affect audit committees of public companies and their response to complaints. The Act contains “whistleblower” provisions that require audit committees to establish procedures for the reporting of complaints. In addition, Section 806 of the Act prohibits retaliation by a publicly traded company against whistleblowers in securities fraud cases and creates a private right of action for aggrieved employees.

Under the provisions in Sarbanes-Oxley, public company audit committees are now required to establish procedures for “(a) the receipt, retention, and treatment of complaints received by the issuer regarding accounting, internal accounting controls, or auditing matters; and (b) the confidential, anonymous submission by employees of the issuer regarding questionable accounting or auditing matters.” [See Public Law 107-204, Title III, Corporate Responsibility, Sec. 301, Public Company Audit Committees.]

See also the Security and Exchange Commission’s (SEC’s) final rule “Standards Relating To Listed Company Audit Committees,” Release No. 33-8220 (April 9, 2003).

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\* Note: This tool is included for illustrative purposes only. It has not been considered or acted upon by any senior technical committee or the AICPA Board of Directors and does not represent an official opinion or position of the AICPA. It is provided with the understanding that the author and publisher are not engaged in rendering legal, accounting, or other professional service. If legal advice or other expert assistance is required, the services of a competent professional should be sought.

**INSTRUCTIONS FOR USING THIS TOOL:** Before using this tool, the audit committee should review the applicable provisions of the Sarbanes-Oxley Act of 2002, and the appropriate rules promulgated by the SEC and other regulatory bodies.

Sample Tracking Report						
Date Submitted	Tracking Number	Description of Complaint	Submitted By*	Current Status:**	Actions Taken	
					Date	Comments

\* Submitted By Codes: Employee (E); Customer (C); Vendor (V); Shareholder (S); Other (O)

\*\* Current Status Codes: R – Resolved; UI – Under Investigation; D – Dismissed; W – Withdrawn; P – Pending/No Action



## Evaluating the Internal Audit Team: Guidelines and Questions

**PURPOSE OF THIS TOOL:** The sample questions included in this tool are only a starting point to assist the audit committee in evaluating the performance and effectiveness of the internal audit team. Follow-up questions should be considered as appropriate.

### Audit Committee Relationship with the Internal Audit Team

It is in the best interest of all concerned for the audit committee and the internal audit team to maintain a strong positive relationship. The audit committee should view the internal audit team as its eyes and ears about what is going on within the company. The audit committee should promote a relationship of healthy professional skepticism between the chief audit executive and the CFO, though it is these two individuals that will likely spend the most time working with the audit committee.

The audit committee chair and the leader of the internal audit team (the chief audit executive or CAE) should have frequent contact between meetings of the audit committee. In fact, the CAE should have a “solid-line” reporting relationship to the audit committee (with a “dotted-line” reporting relationship to a senior executive in the organization for administrative purposes), and the audit committee should be consulted before the CAE can be hired, fired, or reassigned.

At every audit committee meeting the committee should hold an executive session with the CAE to ask specific questions (see also the tool “Conducting an Audit Committee Executive Session: Guidelines and Questions” in this toolkit). It is best for the audit committee to ask specific, yet open-ended questions, and to probe deeper with the CAE on answers that might be puzzling or incomplete. The CAE should be forthcoming with information including the results of audits conducted as well as audits currently underway. The internal audit team must recognize that it is an agent of the audit committee and not management.

The CAE should be the keeper of the audit committee charter, and should consult with the committee chair and the CFO in developing meeting agendas. Periodically, the CAE should review with the audit committee the staffing needs of the internal audit team, and the competencies of the individuals filling those positions.

In times of cost cutting, the internal audit function may be targeted for reductions along with many other functions in the organization. As a best practice, the internal audit team should not be the victim of a corporate downsizing; in fact, it is at precisely this time that the internal audit team should be doing extra monitoring regarding the safeguarding of corporate assets, the integrity of the internal control system, and related matters.

Discussions between the CAE and the audit committee should also address the competencies of the financial management team. The internal audit team is in the best position to determine whether the financial management team is able to address complex accounting issues on its own, or whether it relies too heavily on the independent auditor or other consultants for evaluation and decision-making.

The audit committee should also promote a positive working relationship between the CAE and the independent auditor. If possible, the independent auditor should rely on the work of the internal auditor to supplement or limit its own testing. Generally accepted auditing standards (GAAS) requires that the independent auditor maintain control of the work being performed on its behalf, and to re-perform some of the testing to reach its own conclusion about the work of the internal auditor.

Finally, the audit committee should periodically assess the performance of the CAE and the internal audit team to ensure that they are appropriate agents of the audit committee in the organization. The following tool includes some sample questions that the audit committee should ask itself in evaluating the effectiveness of the internal audit team.



**INSTRUCTIONS FOR USING THIS TOOL:** The sample questions included in this tool are only a starting point to evaluating the performance and effectiveness of the internal audit team. Audit committee members should ask follow-up questions as appropriate.

Evaluation of Internal Audit Team	Yes	No	Not Sure	Comments
1. Does the department appear to be using its time and resources effectively and efficiently?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
2. Are the department's size and structure adequate to meet its established objectives?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
3. Is the experience level of the internal auditors adequate?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
4. Does the department appear to be objective? What procedures are performed to ensure objectivity?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
5. Is the technical knowledge of the department members sufficient to ensure that duties are performed appropriately?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
6. Does the department have an appropriate continuing education program?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
7. Are there department members with sufficient information systems auditing expertise to address the level of technology used by the organization?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
8. Is the department's work planned appropriately?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
9. Does planning include written audit plans and programs?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	

Evaluation of Internal Audit Team	Yes	No	Not Sure	Comments
10. What types of reports are issued by the internal audit department and to whom?				
Notes:				
11. Are the internal audit reports issued on a timely basis?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
12. Do the internal audit reports include sufficient detail for effective action by management and/or the audit committee?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
13. Does management respond in an appropriate and timely fashion to significant recommendations and comments made by the internal auditors?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
14. Do internal audit procedures encompass operational as well as financial areas?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
15. Was the department's involvement in the annual audit effective?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
16. What could be done in the future to maximize the department's effectiveness and efficiency?				
Notes:				
17. To what extent is outsourcing used in the internal audit function, what areas are outsourced, and to whom are they outsourced?				
Notes:				

Evaluation of Internal Audit Team	Yes	No	Not Sure	Comments
18. Does the internal audit team have a periodic "peer review" performed and, if so, what were the results of the latest review?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
Notes:				
19. What criteria are used to establish and prioritize the annual and long-range internal audit plan?				
Notes:				
20. Is the department's work concentrated in areas of high risk, judgment, and sensitivity?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
21. To what extent does the internal audit team keep itself informed about, and involved in professional activities?				
Notes:				
22. What are the internal auditor's views regarding controls, the risk of fraud, and compliance matters?				
Notes:				
23. Has the charter of the internal audit department been evaluated to determine whether it is still appropriate?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	

[illegible]



## Evaluating the Independent Auditor: Questions to Consider

**PURPOSE OF THIS TOOL:** Under the Sarbanes-Oxley Act of 2002, the audit committee has the responsibility to hire, fire, and evaluate the independent auditor. In discharging this responsibility, the audit committee should answer a series of questions about its relationship with the independent auditor, and should ask key executives in the organization for their comments as well.

In considering information gathered through the process of evaluating the independent auditor, it is important that the audit committee give consideration to the source of the information. For example, if the CFO/controller comments that they believe the auditor went too far in certain areas, that would probably carry less weight in your deliberations than if the CFO/controller comments that certain areas were not tested adequately. As with all deliberative processes, the audit committee should consider the different perspectives and motivations of those having input into the deliberations.

**INSTRUCTIONS FOR USING THIS TOOL:** The sample questions included in this tool are only a starting point to evaluating the performance and effectiveness of the independent auditor. Audit committee members should ask follow-up questions as appropriate and required.

Evaluation of the Independent Auditor	Yes	No	Not sure	Comments
<i>Questions for Audit Committee Members</i>				
1. Did the auditor meet with the audit committee when requested?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
2. Did the auditor address issues of “tone at the top” and antifraud programs and controls in place in the organization?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
3. Did the auditor inform the audit committee of any risks, of which the committee was not previously aware?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
4. Did the auditor adequately discuss issues of the quality of financial reporting, including the applicability of new and significant accounting principles?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
5. Did the auditor communicate issues freely with the audit committee, or did the auditor seem protective of management?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
6. Does it appear that management exercises undue influence on the independent auditor?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
7. Does it appear that the independent auditor is reluctant or hesitant to raise issues that would reflect negatively on management?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
8. Is the audit committee satisfied with the planning and conduct of the audit, including the financial statements and internal control over financial reporting (as applicable)?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
9. Review all audit-related and nonaudit services conducted by the independent auditor in the prior year. Are you satisfied that the independent auditor remains independent and objective both in fact and appearance?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	

Evaluation of the Independent Auditor	Yes	No	Not sure	Comments
<i>Questions for Audit Committee Members (cont.)</i>				
10. Understand the size of the firm and its total revenues firm-wide, for the office(s) providing a substantial amount of services to the organization, and the book-of-business of the partner-in-charge of the audit. Is the firm, the office or the partner dependent on the organization for a material percentage of its fee income? If so, the audit committee should consider whether this impairs the appearance of independence with respect to the organization.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
11. a. How is the concurring partner (if applicable) compensated?				
<i>Notes:</i>				
b. Is the concurring partner "protected" in the event a tough call needs to be made?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
12. Is the audit committee satisfied with its relationship with the auditor? In making this determination, the audit committee should consider (a) whether the partner-in-charge of the audit participated in audit committee meetings, (b) whether the auditor was frank and complete in the required discussions with the audit committee, (c) whether the auditor was frank and complete during executive sessions with the audit committee, (d) whether the auditor is on-time in their delivery of services to the company.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
13. Was the audit fee fair and reasonable in relation to what audit committees know about fees charged to other companies, and in line with fee benchmarking data the audit committee might have available to it?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
14. Did the independent auditor provide constructive observations, implications, and recommendations in areas needing improvement, particularly with respect to the organization's internal control system over financial reporting?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
Evaluation of the Independent Auditor	Yes	No	Not sure	Comments
<i>Following are some questions the audit committee should ask different individuals in the organization to assist in evaluating the performance of the independent auditor.</i>				
<i>Chief Audit Executive</i>				

1. From your perspective in working with the independent auditor, are you satisfied with the scope, nature, extent, and timing of testing performed by the independent auditor?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
2. Did the independent auditor work with you to ensure the coordination of audit efforts to assure the completeness of coverage, reduction of redundant efforts, and the effective use of audit resources?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
3. a. Are you satisfied with the knowledge, skills, and abilities of the staff assigned to do the audit work?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
b. Are you satisfied with the engagement leadership assigned, including the partner(s), manager(s) and fieldwork leaders?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
4. a. Did the independent auditor work with the internal auditors according to the plan?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
b. Was cooperative work conducted in the spirit of professionalism and mutual respect?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
5. Are you satisfied that the independent auditor remains independent of the company in spite of any audit-related, or nonaudit services the auditor provides to the organization?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
6. a. Are you aware of any other information that might impair the independence of the independent audit firm?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
b. Are you aware of any individuals on the audit team that might not be independent with respect to the company for whatever reason?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
7. a. If the choice were yours, would you hire the firm to conduct next year's audit?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
b. If so, what changes would you make?				
Notes:				

Evaluation of the Independent Auditor	Yes	No	Not sure	Comments
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CFO/Controller				
1. From your perspective in working with the independent auditor, are you satisfied with the scope, nature, extent, and timing of testing performed by the independent auditor?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
2. Are you satisfied with the knowledge, skills, and abilities of the staff assigned to the audit work?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
3. Are you satisfied with the engagement leadership assigned, including the partner(s), manager(s), and fieldwork leaders?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
4. a. If the choice were yours, would you hire the firm to conduct next year's audit?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
b. If so, what changes would you make?				
Notes:				
Independent Auditor				
1. Is the firm registered with the PCAOB as required if the firm audits public companies?	<input type="checkbox"/>	<input type="checkbox"/>		
2. What were the results of the firm's peer review and/or PCAOB inspection?				
Notes:				

Other Comments, Further Questions				



## Conducting an Audit Committee Self-Evaluation: Guidelines and Questions

**PURPOSE OF THIS TOOL:** Auditing committees should conduct a self-evaluation on an annual basis. This can be accomplished in a number of different evaluation formats and scenarios (through the use of outside evaluators, a 360-degree evaluation format, and other methods). The sample questions included in this tool are only a starting point to evaluating the performance and effectiveness of the audit committee. Follow-up questions are encouraged and the committee should plan for further action as appropriate.

An audit committee should conduct a comprehensive self-evaluation on an annual basis. The self-evaluation can take different forms, involve a number of participants, and use diverse techniques. Most important, however, the self-evaluation should adopt a straightforward approach that will aid the audit committee in assessing its strengths and weaknesses and lay a foundation for future improvement. Some guidelines in designing the format for self-evaluation would include the following areas of consideration.

1. *Introspection.* Be introspective. Evaluate the audit committee's performance by asking specific questions about the impact it has had on the organization, and most importantly, its financial reporting process, the annual audit, the relationship with the independent auditor, and members of management. Include the chair of the board in this evaluation session and ask for his or her input as well.
2. *Comprehensive.* Conduct 360-degree evaluations of all audit committee members and the committee chair. The chair should consider the result of the audit committee members' evaluations of each other in the context of the chair's evaluation of the members. The chair should consider whether any members of the committee should be rotated off the committee; this should be done in consultation with the chair of the board. The members' attendance record and level of participation should be considered during this process.
3. *Performance Improvement.* Ask the chief audit executive, chief financial officer, chief executive officer, and independent auditor for comments on the performance of the audit committee. Include this constructive feedback in the session referred to at item 1 above.
4. *Competency.* Use tools that are available, including the AICPA Competency Self-Assessment Tool (CAT) to evaluate performance. The CAT is available at <http://www.cpa2biz.com/CPEConferences/CAT.htm>.
5. *Leadership.* The members should talk about the performance of the chair. If the members collectively agree that the chair is not performing at the level needed, then the members should bring their concerns to the attention of the chair of the board, and/or the chair of the corporate governance committee, if there is one.

**INSTRUCTIONS FOR THIS TOOL:** The sample questions provided in this tool are only a starting point to evaluating the performance and effectiveness of the audit committee. Prior to completion, the committee should determine how it can best ensure that responses reflect a forthright exchange of ideas and opinions among audit committee members. The committee should determine how the process should be completed. The following sample questions can be completed anonymously, prior to attending an evaluation discussion meeting, or during a session of the committee. Discuss the following questions and include notes and comments if you feel further action is appropriate.

Audit Committee Self-Evaluation Tool	Yes	No	Not Sure	Comments
1. Does the committee have a positive working relationship with management, the internal auditors and the independent auditors?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
2. Does the committee challenge management, the internal auditors, and the independent auditors with its own view on issues?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
3. Are differences of opinion on issues resolved to the satisfaction of the committee?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
4. Do the members challenge the chair as appropriate?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
5. Is the audit committee charter used as a document to guide the committee in its efforts, and to help guide the committee's agenda? Is the audit committee charter matrix used to document compliance with the precepts of the charter?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
6. Are the members financially literate?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
7. Does the committee engage outside experts as appropriate?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
8. Are the organization's financial reporting processes stronger as a result of management's interactions with the audit committee?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
9. Is the committee cognizant of the line between oversight and management, and does it endeavor to respect that line?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	

Audit Committee Self-Evaluation Tool	Yes	No	Not Sure	Comments
10. Does the committee conduct executive sessions in a manner that offers a "safe haven" to the individual, while at the same time asking tough and necessary questions, evaluating the answers, and pursuing issues that might arise to a satisfactory resolution?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
11. Do audit committee members participate in some form of continuing education to stay abreast of changes in the financial accounting and reporting, regulatory and ethics areas?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
12. Does the committee do its part to ensure the objectivity of the internal audit team?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
13. Does the committee provide constructive feedback to the chief audit executive at least annually?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
<i>Additional Questions</i>				
	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
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	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	

[illegible]



## Common Security and Exchange Commission (SEC) Filings: An Overview

**PURPOSE OF THIS TOOL:** The purpose of this tool is to provide audit committee members with an overview of various Security and Exchange Commission (SEC) Forms and associated filing terms and definitions to assist them in understanding current corporate reporting requirements.

### Overview of the Most Common Corporate Filings\*

The following is a short description of the most common corporate filings made with the SEC. Many of these filings are now made through the SEC's EDGAR system and available electronically.

The guide cannot take the place of the Commission's official rules and regulations. It is not to be used as a legal reference document. Please refer to the federal securities laws and the rules and regulations thereunder (Title 17 of the Code of Federal Regulations, Parts 200 to End) for the official description of the forms mentioned. These are available at most law libraries. They may also be ordered through:

Superintendent of Documents  
Government Printing Office  
Washington, D.C. 20402

or

Securities and Exchange Commission  
Publications Unit  
Mail Stop C-11  
450 Fifth Street, N.W.  
Washington, D.C. 20549

*Form ADV.* This form is used to apply for registration as an investment adviser or to amend a registration. It consists of two parts. Part I contains general and personal information about the applicant. Part II contains information relating to the nature of the applicant's business, including basic operations, services offered, fees charged, types of clients advised, educational and business backgrounds of associates and other business activities of the applicant.

*Annual Report to Shareholders.* The Annual Report to Shareholders is the principal document used by most public companies to disclose corporate information to shareholders. It is usually a state-of-the-company report including an opening letter from the Chief Executive Officer, financial data, results of continuing operations, market segment information, new product plans, subsidiary activities and research and development activities on future programs.

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\* Source: This material is found on the SEC Web site at <http://www.sec.gov/info/edgar/forms.htm#common>

*Form BD.* This form is used to apply for registration as a broker or dealer of securities, or as a government securities broker or dealer, and to amend a registration. It provides background information on the applicant and the nature of its business. It includes lists of the executive officers and general partners of the company. It also contains information on any past securities violations.

*Form D.* Companies selling securities in reliance on a Regulation D exemption or a Section 4(6) exemption from the registration provisions of the '33 Act must file a Form D as notice of such a sale. The form must be filed no later than 15 days after the first sale of securities.

For additional information on Regulation D and Section 4(6) offerings, ask for a copy of the Regulation and the pamphlet entitled: "Q & A: Small Business and the SEC" from the Commission's Publications Unit or see the Small Business section of the Commission's Web site.

*Form 1-A.* Regulation A provides the basis for an exemption for certain small offerings (generally up to \$5 million in any twelve month period). Companies selling securities in reliance on a Regulation A exemption from the registration provisions of the 1933 Act must provide investors with an offering statement meeting the requirements of Form 1-A.

For additional information on Regulation A, ask for a copy of the Regulation and the pamphlet entitled "Q & A: Small Business and the SEC" from the Commission's Publications Unit or see the Small Business section of the Commission's Web site.

*Form MSD.* This report is used by a bank or a separately identifiable department or division of a bank to apply for registration as a municipal securities dealer with the SEC, or to amend such registration.

*Form N-SAR.* This is a report to the Commission filed by registered investment companies on a semi-annual and annual basis, at the end of the corresponding fiscal periods. Unit investment trusts, however, are required to file this form only once a year, at the end of the calendar year. The form contains information about the type of fund that is reporting sales charges, 12b-1 fees, sales of shares, identity of various entities providing services to the investment company, portfolio turnover rate, and selected financial information.

*Prospectus.* The prospectus constitutes Part I of a 1933 Act registration statement. It contains the basic business and financial information on an issuer with respect to a particular securities offering. Investors may use the prospectus to help appraise the merits of the offering and make educated investment decisions.

A prospectus in its preliminary form is frequently called a "red herring" prospectus and is subject to completion or amendment before the registration statement becomes effective, after which a final prospectus is issued and sales can be consummated.

*Proxy Solicitation Materials (Regulation 14A/Schedule 14A).* State law governs the circumstances under which shareholders are entitled to vote. When a shareholder vote is required and any person solicits proxies with respect to securities registered under Section 12 of the 1934 Act, that person generally is required to furnish a proxy statement containing the information specified by Schedule 14A. The proxy statement is intended to provide security holders with the information necessary to enable them to vote in an informed manner on matters intended to be acted upon at security holders' meetings, whether the traditional annual meeting or a special meeting. Typically, a security holder is also provided with a "proxy card" to authorize designated persons to vote his or her securities on the security holder's behalf in the

event the holder does not vote in person at the meeting. Copies of definitive (final) proxy statements and proxy card are filed with the Commission at the time they are sent to security holders. For further information about the applicability of the Commission's proxy rules, see Section 14(a) of the 1934 Act and Regulation 14A.

Certain preliminary proxy filings relating to mergers, consolidations, acquisitions and similar matters are non-public upon filing; all other proxy filings are publicly available.

### 1933 Act Registration Statements

One of the major purposes of the federal securities laws is to require companies making a public offering of securities to disclose material business and financial information in order that investors may make informed investment decisions. The 1933 Act requires issuers to file registration statements with the Commission, setting forth such information, before offering their securities to the public. (See Section 6 of the Securities Act of 1933 for information concerning the "Registration of Securities and Signing of Registration Statement;" Section 8 of the Securities Act of 1933 for information on "Taking Effect of Registration Statements and Amendments Thereto.")

The registration statement is divided into two parts. Part I is the prospectus. It is distributed to interested investors and others. It contains data to assist in evaluating the securities and to make informed investment decisions.

Part II of the registration statement contains information not required to be in the prospectus. This includes information concerning the registrants' expenses of issuance and distribution, indemnification of directors and officers, and recent sales of unregistered securities as well as undertakings and copies of material contracts.

(Investment companies file 1933 Act registration statements that are, in many cases, also registration statements under the Investment Company Act of 1940. For descriptions of registration statements filed by these issuers, see the following section.)

The most widely used 1933 Act registration forms are as follows:

Form Number	Reason for Use
S-1	This is the basic registration form. It can be used to register securities for which no other form is authorized or prescribed, except securities of foreign governments or political sub-divisions thereof.
S-2	This is a simplified optional registration form that may be used by companies that have been required to report under the '34 Act for a minimum of three years and have timely filed all required reports during the 12 calendar months and any portion of the month immediately preceding the filing of the registration statement. Unlike Form S-1, it permits incorporation by reference from the company's annual report to stockholders (or annual report on Form 10-K) and periodic reports. Delivery of these incorporated documents as well as the prospectus to investors may be required.



Form Number	Reason for Use
S-3	This is the most simplified registration form and it may only be used by companies that have been required to report under the '34 Act for a minimum of twelve months and have met the timely filing requirements set forth under Form S-2. Also, the offering and issuer must meet the eligibility tests prescribed by the form. The form maximizes incorporating by reference information from '34 Act filings.
S-4	This form is used to register securities in connection with business combinations and exchange offers.
S-8	This form is used for the registration of securities to be offered to an issuer's employees pursuant to certain plans.
S-11	This form is used to register securities of certain real estate companies, including real estate investment trusts.
SB-1	This form may be used by certain "small business issuers" to register offerings of up to \$10 million of securities, provided that the company has not registered more than \$10 million in securities offerings during the preceding twelve months. This form requires less detailed information about the issuer's business than Form S-1. Generally, a "small business issuer" is a U.S. or Canadian company with revenues and public market float less than \$25 million.
SB-2	This form may be used by "small business issuers" to register securities to be sold for cash. This form requires less detailed information about the issuer's business than Form S-1.
S-20	This form may be used to register standardized options where the issuer undertakes not to issue, clear, guarantee or accept an option registered on Form S-20 unless there is a definitive options disclosure document meeting the requirements of Rule 9b-1 of the '34 Act.
Sch B	Schedule B is the registration statement used by foreign governments (or political subdivisions of foreign governments) to register securities. Generally, it contains a description of the country and its government, the terms of the offering, and the uses of proceeds.
F-1	This is the basic registration form authorized for certain foreign private issuers. It is used to register the securities of those eligible foreign issuers for which no other more specialized form is authorized or prescribed.
F-2	This is an optional registration form that may be used by certain foreign private issuers that have an equity float of at least \$75 million worldwide or are registering non-convertible investment grade securities or have reported under the '34 Act for a minimum of three years. The form is somewhat shorter than Form F-1 because it uses delivery of filings made by the issuer under the '34 Act, particularly Form 20-F.
F-3	This form may only be used by certain foreign private issuers that have reported under the '34 Act for a minimum of twelve months and that have a worldwide public market float of more than \$75 million. The form also may be used by eligible foreign private issuers to register offerings of non-convertible investment grade securities, securities to be sold by selling security holders, or securities to be issued to certain existing security holders. The form allows '34 Act filings to be incorporated by reference.

Form Number	Reason for Use
F-4	This form is used to register securities in connection with business combinations and exchange offers involving foreign private issuers.
F-6	This form is used to register depository shares represented by American Depositary Receipts (“ADRs”) issued by a depositary against the deposit of the securities of a foreign issuer.
F-7	This form is used by certain eligible publicly traded Canadian foreign private issuers to register rights offers extended to their U.S. shareholders. Form F-7 acts as a wraparound for the relevant Canadian offering documents. To be registered on Form F-7, the rights must be granted to U.S. shareholders on terms no less favorable than those extended to other shareholders.
F-8	This form may be used by eligible large publicly traded Canadian foreign private issuers to register securities offered in business combinations and exchange offers. Form F-8 acts as a wraparound for the relevant Canadian offering or disclosure documents. The securities must be offered to U.S. holders on terms no less favorable than those extended to other holders.
F-9	This form may be used by eligible large publicly traded Canadian foreign private issuers to register non-convertible investment grade securities. Form F-9 acts as a wraparound for the relevant Canadian offering documents.
F-10	This form may be used by eligible large publicly traded Canadian foreign private issuers to register any securities (except certain derivative securities). Form F-10 acts as a wraparound for the relevant Canadian offering documents. Unlike Forms F-7, F-8, F-9, and F-80, however, Form F-10 requires the Canadian issuer to reconcile its financial statements to U.S. Generally Accepted Accounting Principles (“GAAP”).
F-80	This form may be used by eligible large publicly traded Canadian foreign private issuers to register securities offered in business combinations and exchange offers. Form F-80 acts as a wraparound for the relevant Canadian offering or disclosure documents. The securities must be offered to U.S. holders on terms no less favorable than those extended to other holders.
SR	This form is used as a report by first time registrants under the Act of sales of registered securities and use of proceeds therefrom. The form is required at specified periods of time throughout the offering period, and a final report is required after the termination of the offering.

## Investment Company Registration Statements

Investment companies also register their securities under the 1933 Act. However, many of the forms used are also used as registration statements under the Investment Company Act of 1940.

Mutual funds, the most common type of registered investment company, make a continuous offering of their securities and register on Form N-1A, a simplified, three-part form. The prospectus, or Part A, provides a concise description of the fundamental characteristics of the initial fund in a way that will assist investors in making informed decisions about whether to purchase the securities of the fund. The

statement of additional information, Part B, contains additional information about the fund, which may be of interest to some investors but need not be included in the prospectus. Part C contains other required information and exhibits.

Closed-end funds, Unit investment trusts, insurance company separate accounts, business development companies and other registered investment companies register their securities and provide essential information about them on other registration forms, as listed below. All the forms listed are used for registration under both the 1933 Act and 1940 Act unless otherwise indicated.

Form Number	Reason for Use
N-1A	This form is used to register open-end management investment companies ("mutual funds").
N-2	This form is used to register closed-end management investment companies ("closed-end funds").
N-3	This form is used to register insurance company separate accounts organized as management investment companies offering variable annuity contracts.
N-4	This form is used to register insurance company separate accounts organized as unit investment trusts offering variable annuity contracts.
S-6	This form is used to register securities issued by unit investment trusts (1933 Act only).
N-14	This form is used to register securities issued by investment companies in connection with business combinations and mergers (1933 Act only).

*Other Securities Act Form: Form 144.* This form must be filed as notice of the proposed sale of restricted securities or securities held by an affiliate of the issuer in reliance on Rule 144 when the amount to be sold during any three month period exceeds 500 shares or units or has an aggregate sales price in excess of \$10,000.

### **1934 Act Registration Statements**

All companies whose securities are registered on a national securities exchange, and, in general, other companies whose total assets exceed \$10,000,000 (\$10 million) with a class of equity securities held by 500 or more persons, must register such securities under the 1934 Act. (See Section 12 of the '34 Act for further information.)

This registration establishes a public file containing material financial and business information on the company for use by investors and others, and also creates an obligation on the part of the company to keep such public information current by filing periodic reports on Forms 10-Q and 10-K, and on current event Form 8-K, as applicable.

In addition, if registration under the 1934 Act is not required, any issuer who conducts a public offering of securities must file reports for the year in which it conducts the offering (and in subsequent years if the securities are held by more than 300 holders).

The most widely used 1934 Act registration forms are as follows:

Form Number	Reason for Use
10	This is the general form for registration of securities pursuant to section 12(b) or (g) of the '34 Act of classes of securities of issuers for which no other form is prescribed. It requires certain business and financial information about the issuer.
10-SB	This is the general form for registration of securities pursuant to Sections 12(b) or (g) of the '34 Act for "small business issuers." This form requires slightly less detailed information about the company's business than Form 10 requires.
8-A	This optional short form may be used by companies to register securities under the '34 Act.
8-B	This specialized registration form may be used by certain issuers with no securities registered under the '34 Act that succeed to another issuer which had securities so registered at the time of succession.
20-F	This is an integrated form used both as a registration statement for purposes of registering securities of qualified foreign private issuers under Section 12 or as an annual report under Section 13(a) or 15(d) of the '34 Act.
40-F	This is an integrated form used both as a registration statement to register securities of eligible publicly traded Canadian foreign private issuers or as an annual report for such issuers. It serves as a wraparound for the company's Canadian public reports.

### Other Exchange Act Forms

*Form TA-1.* This form is used to apply for registration as a transfer agent or to amend such registration. It provides information on the company's activities and operation.

*Form X-17A-5.* Every broker or dealer registered pursuant to Section 15 of the Exchange Act must file annually, on a calendar or fiscal year basis, a report audited by an independent public accountant.

*Forms 3, 4 and 5.* Every director, officer or owner of more than ten percent of a class of equity securities registered under Section 12 of the '34 Act must file with the Commission a statement of ownership regarding such security. The initial filing is on Form 3 and changes are reported on Form 4. The Annual Statement of beneficial ownership of securities is on Form 5. The forms contain information on the reporting person's relationship to the company and on purchases and sales of such equity securities.

*Form 6-K.* This report is used by certain foreign private issuers to furnish information: (i) required to be made public in the country of its domicile; (ii) filed with and made public by a foreign stock exchange on which its securities are traded; or (iii) distributed to security holders. The report must be furnished promptly after such material is made public. The form is not considered "filed" for Section 18 liability purposes. This is the only information furnished by foreign private issuers between annual reports, since such issuers are not required to file on Forms 10-Q or 8-K.

*Form 8-K.* This is the "current report" that is used to report the occurrence of any material events or corporate changes which are of importance to investors or security holders and previously have not been

reported by the registrant. It provides more current information on certain specified events than would Forms 10-Q or 10-K.

*Form 10-C.* This form must be filed by an issuer whose securities are quoted on the Nasdaq interdealer quotation system. Reported on the form is any change that exceeds five percent in the number of shares of the class outstanding and any change in the name of the issuer. The report must be filed within ten days of such change.

*Form 10-K.* This is the annual report that most reporting companies file with the Commission. It provides a comprehensive overview of the registrant's business. The report must be filed within 90 days after the end of the company's fiscal year.

*Form 10-KSB.* This is the annual report filed by reporting "small business issuers." It provides a comprehensive overview of the company's business, although its requirements call for slightly less detailed information than required by Form 10-K. The report must be filed within 90 days after the end of the company's fiscal year.

*Form 10-Q.* The Form 10-Q is a report filed quarterly by most reporting companies. It includes unaudited financial statements and provides a continuing view of the company's financial position during the year. The report must be filed for each of the first three fiscal quarters of the company's fiscal year and is due within 45 days of the close of the quarter.

*Form 10-QSB.* The Form 10-QSB is filed quarterly by reporting small business issuers. It includes unaudited financial statements and provides a continuing view of the company's financial position and results of operations throughout the year. The report must be filed for each of the first three fiscal quarters and is due within 45 days of the close of the quarter.

*Form 11-K.* This form is a special annual report for employee stock purchase, savings, and similar plans, interests in which constitute securities registered under the 1933 Act. The Form 11-K annual report is required in addition to any other annual report of the issuer of the securities (e.g., a company's annual report to all shareholders or Form 10-K).

*Form 12b-25.* This form is used as a notification of late filing by a reporting company that determines that it is unable to file a required periodic report when first due without unreasonable effort or expense. If a company files a Form 12b-25, it is entitled to relief, but must file the required report within five calendar days (for a Form 10-Q or 10-QSB) or within fifteen calendar days (for a Form 10-K, 10-KSB, 20-F, 11-K, or N-SAR).

*Form 13F.* This is a quarterly report of equity holdings by institutional investment managers having equity assets under management of \$100 million or more. Included in this category are certain banks, insurance companies, investment advisers, investment companies, foundations and pension funds.

*Form 15.* This form is filed by a company as notice of termination of registration under Section 12(g) of the '34 Act, or suspension of the duty to file periodic reports under Sections 13 and 15(d) of the '34 Act.

*Form 18.* This form is used for the registration on a national securities exchange of securities of foreign governments and political subdivisions thereof.

*Form 18-K.* This form is used for the annual reports of foreign governments or political subdivisions thereof.

*Schedule 13D.* This schedule discloses beneficial ownership of certain registered equity securities. Any person or group of persons who acquire a beneficial ownership of more than 5% of a class of registered equity securities of certain issuers must file a Schedule 13D reporting such acquisition together with certain other information within ten days after such acquisition. Moreover, any material changes in the facts set forth in the schedule generally precipitates a duty to promptly file an amendment on Schedule 13D.

The Commission's rules define the term "beneficial owner" to be any person who directly or indirectly shares voting power or investment power (the power to sell the security).

*Schedule 13G.* Schedule 13G is a much abbreviated version of Schedule 13D that is only available for use by a limited category of "persons" (such as banks, broker/dealers, and insurance companies) and even then only when the securities were acquired in the ordinary course of business and not with the purpose or effect of changing or influencing the control of the issuer.

*Schedule 13E-3.* This schedule must be filed by certain persons engaging in "going private" transactions. The schedule must be filed by any company or an affiliate of a company who engages in a business combination, tender offer, or stock purchase that has the effect of causing a class of the company's equity securities registered under the 1934 Act (1) to be held by fewer than 300 persons, or (2) to be de-listed from a securities exchange or inter-dealer quotation system. The filer must disclose detailed information about the transaction, including whether the filer believes the transaction to be fair.

*Schedule 13E-4.* This schedule (called an Issuer Tender Offer Statement) must be filed by certain reporting companies that make tender offers for their own securities. In addition, Rule 13e-4 under the 1934 Act imposes additional requirements that an issuer must comply with when making an issuer tender offer.

*Schedule 13E-4F.* This schedule may be used by a Canadian foreign private issuer that makes an issuer tender offer for its equity shares (provided that U.S. holders hold less than 40 percent of the class of shares subject to the offer). It serves as a wraparound for the relevant Canadian disclosure documents. The Canadian issuer must comply with relevant Canadian tender offer regulations.

*Information Statement (Regulation 14C/Schedule 14C).* Schedule 14C sets forth the disclosure requirements for information statements. Generally, a company with securities registered under Section 12 of the '34 Act must send an information statement to every holder of the registered security who is entitled to vote on any matter for which the company is not soliciting proxies. (If the company solicits proxies, Regulation 14C/Schedule 14A may be required.)

*Schedule 14D-1.* Any person, other than the issuer itself (see Schedule 13E-4), making a tender offer for certain equity securities registered pursuant to Section 12 of the '34 Act, which offer, if accepted, would cause that person to own over 5 percent of that class of the securities, must at the time of the offer file a Schedule 14D-1. This schedule must be filed with the Commission and sent to certain other parties, such as the issuer and any competing bidders. In addition, Regulation 14D sets forth certain requirements that must be complied with in connection with a tender offer.

*Schedule 14D-1F.* Any person making a tender offer for securities of a Canadian foreign private issuer may use this schedule if U.S. holders hold less than 40 percent of the class of securities that is the subject of

the offer and if the bidder extends the tender offer to U.S. holders on terms that are at least as favorable as those extended to any other holder. The schedule serves as a wraparound for the relevant Canadian disclosure documents. In addition, the tender offer must comply with relevant Canadian requirements.

*Schedule 14D-9.* This schedule must be filed with the Commission when an interested party, such as an issuer, a beneficial owner of securities, or a representative of either, makes a solicitation or recommendation to the shareholders with respect to a tender offer which is subject to Regulation 14D.

*Schedule 14D-9F.* Schedule 14D-9F may be used by a Canadian foreign private issuer or by any of its directors or officers when the issuer is the subject of a tender offer filed on Schedule 14D-1F. The schedule is used to respond to tender offers. The schedule serves as a wraparound for the relevant Canadian disclosure documents. In addition, the filer must comply with all relevant Canadian requirements.

### **Trust Indenture Act of 1939—Forms**

Form Number	Reason for Use
T-1	This form is a statement of eligibility and qualification of a corporation to act as a trustee under the Trust Indenture Act of 1939.
T-2	This form is basically the same as Form T-1, except it is to be used for individual, rather than corporate trustees.
T-3	This form is used as an application for qualification of indentures pursuant to the Trust Indenture Act of 1939, but only when securities to be issued thereunder are not required to be registered under the Securities Act of 1933.
T-4	This form is used to apply for an exemption from certain provisions of the Trust Indenture Act.
T-6	This form is used by a foreign corporation as an application to act as sole trustee under an indenture qualified under the Trust Indenture Act.





## SEC Final Rule on Audit Committee Financial Experts\*

**PURPOSE OF THIS TOOL:** The purpose of this tool is to provide audit committee members with an overview of the SEC Final Rule “Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002”, which defines the term “financial expert” and how that term applies to the audit committee, especially in relationship to required disclosures.

### A. Audit Committee Financial Experts

#### 1. Title of the Expert

In the Proposing Release, we solicited comment as to whether we should use the term “financial expert” in our rules consistent with its use in Section 407 of the Sarbanes-Oxley Act, or whether a different term such as “audit committee financial expert” would be more appropriate. A number of commenters expressed a concern that neither the term “financial expert” nor “audit committee financial expert” accurately reflects the required experience and expertise of the type of expert contemplated by Section 407 and our proposed rules. Some noted that many of the key characteristics included in our proposed definition of a financial expert relate to the expert’s accounting knowledge and experience in an accounting or auditing position. One commenter therefore recommended that we use the term “audit committee accounting expert.” Other suggested terms included “accounting expert,” “audit committee member financial lead” and “financially proficient director.”

We agree that the term “financial” may not completely capture the attributes referenced in Section 407, given the provision’s focus on accounting and auditing expertise and the fact that traditional “financial” matters extend to capital structure, valuation, cash flows, risk analysis and capital-raising techniques. Furthermore, several recent articles on the proposals have noted that many experienced investors and business leaders with considerable financial expertise would not necessarily qualify as financial experts under the proposed definition.<sup>14</sup> We have decided to use the term “audit committee financial expert” in our rules implementing Section 407 instead of the term “financial expert.”<sup>15</sup> This term suggests more pointedly that the designated person has characteristics that are particularly relevant to the functions of the audit committee, such as: a thorough understanding of the audit committee’s oversight role, expertise in accounting matters as well as understanding of financial statements, and the ability to ask the right questions to determine whether the company’s financial statements are complete and accurate. The new rules include a definition of the term “audit committee financial expert.”<sup>16</sup>

#### 2. Disclosure of the Number and Names of Audit Committee Financial Experts

A substantial number of commenters opposed our proposal to require a company to disclose the number and names of the persons that the company’s board determined to be audit committee financial experts. Some were opposed on the ground that our proposed rules exceeded the mandates of the Sarbanes-

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\* This material is excerpted from SEC Final Rule: “Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002”, Release Nos. 33-8177; 34-47235, March 28, 2003, with correction release. See <http://www.sec.gov/rules/final/33-8177.htm> for text of the complete rule.



Oxley Act.<sup>17</sup> Much of the opposition stemmed from a fear that the designation of an audit committee financial expert may inappropriately suggest that the expert bears greater responsibility, and therefore is subject to a higher degree of liability, for audit committee decisions than other audit committee members. Some commenters thought that identification of the audit committee financial expert in the company's annual report would exacerbate that problem and discourage qualified persons from serving as such experts.

We have modified the proposals that would have required disclosure of the number and names of audit committee financial experts serving on a company's audit committee to more closely track the language used in Section 407 of the Sarbanes-Oxley Act. Under the rules that we are adopting, a company must disclose that its board of directors has determined that the company either:

- has at least one audit committee financial expert serving on its audit committee; or
- does not have an audit committee financial expert serving on its audit committee.

A company disclosing that it does not have an audit committee financial expert must explain why it does not have such an expert. We continue to believe that disclosure of the name of the audit committee financial expert is necessary to benefit investors and to carry out the purpose of Section 407. Therefore, under the final rules, if a company discloses that it has an audit committee financial expert, it also must disclose the expert's name. We believe that, in general, omission of the expert's name ultimately would not result in the expert's identity remaining non-public. To the extent that there are liability concerns, we believe that they are best addressed by our inclusion of a safe harbor in our rules, as discussed below.

The final rules permit, but do not require, a company to disclose that it has more than one audit committee financial expert on its audit committee. Therefore, once a company's board determines that a particular audit committee member qualifies as an audit committee financial expert, it may, but is not required to, determine whether additional audit committee members also qualify as experts. Every company subject to the audit committee disclosure requirements would, however, have to determine whether or not it has at least one audit committee financial expert; a company will not satisfy the new disclosure requirements by stating that it has decided not to make a determination or by simply disclosing the qualifications of all of its audit committee members. Furthermore, if the company's board determines that at least one of the audit committee members qualifies as an expert, the company must accurately disclose this fact. It will not be appropriate for a company to disclose that it does not have an audit committee financial expert if its board has determined that such an expert serves on the audit committee.

### 3. Disclosure of Independence of Audit Committee Financial Experts

We proposed to require a company to disclose whether its audit committee financial expert is independent of management. A number of commenters opposed this disclosure requirement as unnecessary, noting that Section 301 of the Sarbanes-Oxley Act mandates the Commission to direct the self-regulatory organizations to prohibit the listing of any company that does not require all of its audit committee members to be independent. However, not all Exchange Act reporting companies are listed on a national securities exchange or association.<sup>18</sup> We believe that investors in these companies would be interested in knowing whether the audit committee financial expert is independent of management. Therefore, the final rules require a company to disclose whether the person or persons identified as the audit committee financial expert is independent of management.

In the proposing release, we defined "independent" by reference to Section 10A(m)(3) of the Exchange Act.<sup>19</sup> Several commenters noted that this reference may cause some confusion because the securities laws include different definitions of the term "affiliated," which is part of the definition used in Section 10A(m)(3).<sup>20</sup> Therefore, to provide clarity, the final rules refer to the definition of "independent" used in Item

7(d)(3)(iv) of Schedule 14A.<sup>21</sup> This revision ensures that the term “independent” is used consistently in our rules.<sup>22</sup>

#### 4. Definition of “Audit Committee Financial Expert”

##### *a. Proposed Definition of the Term “Financial Expert”*

We proposed to define the term “financial expert” to mean a person who has, through education and experience as a public accountant, auditor, principal financial officer, controller or principal accounting officer, of a company that, at the time the person held such position, was required to file reports pursuant to Section 13(a) or 15(d) of the Exchange Act, or experience in one or more positions that involve the performance of similar functions (or that results, in the judgment of the company’s board of directors, in the person’s having similar expertise and experience),<sup>23</sup> the following attributes:

- (1) An understanding of generally accepted accounting principles and financial statements;
- (2) Experience applying such generally accepted accounting principles in connection with the accounting for estimates, accruals, and reserves that are generally comparable to the estimates, accruals and reserves, if any, used in the registrant’s financial statements;
- (3) Experience preparing or auditing financial statements that present accounting issues that are generally comparable to those raised by the registrant’s financial statements;
- (4) Experience with internal controls and procedures for financial reporting; and
- (5) An understanding of audit committee functions.

In addition, the proposed rule would have provided guidance to companies by providing a list of factors to be considered in making that evaluation, including:

- The level of the person’s accounting or financial education, including whether the person has earned an advanced degree in finance or accounting;
- Whether the person is a certified public accountant, or the equivalent, in good standing, and the length of time that the person actively has practiced as a certified public accountant, or the equivalent;
- Whether the person is certified or otherwise identified as having accounting or financial experience by a recognized private body that establishes and administers standards in respect of such expertise, whether that person is in good standing with the recognized private body, and the length of time that the person has been actively certified or identified as having this expertise;
- Whether the person has served as a principal financial officer, controller or principal accounting officer of a company that, at the time the person held such position, was required to file reports pursuant to Section 13(a) or 15(d) of the Exchange Act, and if so, for how long;
- The person’s specific duties while serving as a public accountant, auditor, principal financial officer, controller, principal accounting officer or position involving the performance of similar functions;
- The person’s level of familiarity and experience with all applicable laws and regulations regarding the preparation of financial statements that must be included in reports filed under Section 13(a) or 15(d) of the Exchange Act;
- The level and amount of the person’s direct experience reviewing, preparing, auditing or analyzing financial statements that must be included in reports filed under Section 13(a) or 15(d) of the Exchange Act;

- The person's past or current membership on one or more audit committees of companies that, at the time the person held such membership, were required to file reports pursuant to Section 13(a) or 15(d) of the Exchange Act;
- The person's level of familiarity and experience with the use and analysis of financial statements of public companies; and
- Whether the person has any other relevant qualifications or experience that would assist him or her in understanding and evaluating the registrant's financial statements and other financial information and to make knowledgeable and thorough inquiries whether:
  - The financial statements fairly present the financial condition, results of operations and cash flows of the company in accordance with generally accepted accounting principles; and
  - The financial statements and other financial information, taken together, fairly present the financial condition, results of operations and cash flows of the company.

*b. Comments on Proposed Definition*

The proposed definition of the term “financial expert” proved to be the most controversial aspect of the proposals—more commenters remarked on it than on any other topic addressed by the proposed rules. Most of the commenters thought that the proposed definition was too restrictive. Several expressed concern that many companies, especially small ones, would have a difficult time attracting an audit committee member who would qualify as an expert under the proposed definition. Some of the corporate commenters were of the view that they already have exemplary audit committees, despite the fact that none of their current members would meet our proposed definition of an expert. A few complained that companies may have to sacrifice the diversity of their boards and nominate directors who satisfy the audit committee financial expert definition even if the company does not believe that these directors are best-suited for the position.

Furthermore, several commenters debated the merits of defining an audit committee financial expert as a person with strong accounting credentials, given that an audit committee member's role is one of oversight, rather than direct involvement in the company's accounting functions, and suggested that the emphasis on technical accounting expertise in the definition was misplaced. A few commenters further argued that it is unnecessary to have a financial expert serving on the audit committee because audit committee members should have the discretion to retain experts with specific financial expertise as they deem necessary or appropriate.

Other commenters asserted that the proposed definition was more restrictive than necessary to satisfy Congressional intent—they noted that Section 407 of the Sarbanes-Oxley Act requires us, in defining the term “financial expert,” only to “consider” whether a person has, through education and experience as a public accountant, auditor, principal financial officer, comptroller, principal accounting officer, or similar position, the four attributes specified in the Act.<sup>24</sup> These commenters argued that in light of the Congressional directive only to consider the four attributes, our proposed definition did not need to incorporate all of them, or even any of them. Some commenters believed that a single member of the audit committee should not have to possess all of the required financial expert attributes so long as the members of the audit committee collectively possess these attributes. Others suggested various permutations such as requiring the financial expert to have the first and fifth attributes in our proposed definition, but only two of the other three attributes.

Many commenters criticized specific provisions of the proposed financial expert definition as being too narrow. In particular, many commenters asserted that our proposed requirement that an expert have direct experience preparing or auditing financial statements was greatly, and needlessly, restrictive. Other

commenters were concerned that the requirement that a person have had experience with financial statements presenting issues generally comparable to those raised by the company's financial statements might have anti-competitive effects if we interpreted this requirement to mean that a financial expert would need previous experience with financial statements of other companies in the same industry.

Several commenters sought clarification regarding the relevant body of generally accepted accounting principles, in particular for financial experts of foreign private issuers. Other commenters expressed concern over the possible lack of potential financial experts that would be knowledgeable about accounting for estimates and reserves in specific industries, such as the insurance and oil industries.

Numerous additional commenters were concerned that the proposed definition was too restrictive regarding the means by which a person could acquire the required expertise to qualify as a financial expert. They suggested that a requirement that an expert have experience as a public accountant, auditor, principal financial officer, controller, principal accounting officer or in a similar position, would severely limit the number of persons qualified to be financial experts. Some believed that there are a substantial number of highly qualified persons who have sufficient knowledge and experience to effectively and competently perform the activities required of a financial expert, but do not have experience in one of the listed positions. They questioned the relevance of the means by which a person acquires the necessary expertise, so long as the person in fact has such expertise.

*c. Final Definition of "Audit Committee Financial Expert"*

The final rules define an audit committee financial expert as a person who has the following attributes:

- An understanding of generally accepted accounting principles and financial statements;
- The ability to assess the general application of such principles in connection with the accounting for estimates, accruals and reserves;
- Experience preparing, auditing, analyzing or evaluating financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to the breadth and complexity of issues that can reasonably be expected to be raised by the registrant's financial statements, or experience actively supervising one or more persons engaged in such activities;
- An understanding of internal controls and procedures for financial reporting; and
- An understanding of audit committee functions.<sup>25</sup>

Under the final rules, a person must have acquired such attributes through any one or more of the following:

- (1) Education and experience as a principal financial officer, principal accounting officer, controller, public accountant or auditor or experience in one or more positions that involve the performance of similar functions;
- (2) Experience actively supervising a principal financial officer, principal accounting officer, controller, public accountant, auditor or person performing similar functions;
- (3) Experience overseeing or assessing the performance of companies or public accountants with respect to the preparation, auditing or evaluation of financial statements; or
- (4) Other relevant experience.<sup>26</sup>

*d. Discussion of Significant Modifications to the Proposed Definition of “Financial Expert”*

We have made several changes to our proposed definition of a financial expert. As already discussed, we have decided to use the term audit committee financial expert rather than financial expert in the final rules. We also have reorganized the components of the definition to make it easier to read and to emphasize, by including them in the first part of the definition, the attributes that an audit committee financial expert must possess. The second part of the definition discusses the means by which a person must acquire the necessary attributes. We also have eliminated the proposed instruction listing several factors that a company’s board of directors should consider in evaluating the education and experience of an audit committee financial expert candidate.

Proposed attributes of a financial expert.

- i. *The financial expert must have an understanding of generally accepted accounting principles and financial statements.*

We are adopting this attribute substantially as proposed. However, in response to comments, we have added an instruction to clarify that, with respect to foreign private issuers, the audit committee financial expert’s understanding must be of the generally accepted accounting principles used by the foreign private issuer in preparing its primary financial statements filed with the Commission.<sup>27</sup> Our rules require foreign private issuers that do not prepare their primary financial statements in accordance with U.S. generally accepted accounting principles to include a reconciliation to those principles in the financial statements that they file with the Commission. Although an understanding of reconciliation to U.S. generally accepted accounting principles would be helpful, we believe that the proper focus of audit committee financial expertise is on the principles used to prepare the primary financial statement. We also are sensitive to the fact that requiring an audit committee financial expert to possess expertise relating to U.S. generally accepted accounting principles could burden foreign private issuers who use home country accounting principles or international accounting standards to prepare their primary financial statements.

- ii. *The financial expert must have experience applying such generally accepted accounting principles in connection with the accounting for estimates, accruals and reserves that are generally comparable to the estimates, accruals and reserves, if any, used in the registrant’s financial statements.*

Several commenters were concerned that potential audit committee financial experts would not have experience with the unique and complex accounting for estimates, accruals and reserves in certain industries, such as the insurance industry, unless they have had direct previous experience in these industries. The commenters further noted that there could be a very limited pool of audit committee financial expert candidates available with such experience that would not have ties to a competitor within the same industry. In light of these comments, we have revised this attribute by eliminating the clause “that are generally comparable to the estimates, accruals and reserves, if any, used in the registrant’s financial statements.” We also have revised this attribute to state that the audit committee financial expert must have the ability to assess the general application of generally accepted accounting principles in connection with the accounting for estimates, accruals and reserves, rather than stating that the expert must have experience applying these principles.<sup>28</sup> We believe that this description of the attribute better satisfies the intent of the statute and better reflects the role to be played by audit committees. We recognize that the pool of persons possessing the highly specialized technical knowledge that some thought the proposals necessitated may be so small that a substantial percentage of companies in certain industries would be compelled to disclose that they could not retain an expert without recruiting a person associated with a competitor. We do not intend for the new requirements to lead to such a result. An audit committee financial expert must be able to assess the general application of generally accepted accounting principles

in connection with accounting for estimates, accruals and reserves. This general attribute provides the necessary background for an audit committee when addressing more detailed industry-specific standards or other particular topics. Experience with such detailed standards or topics is not a necessary attribute of audit committee financial expertise.

- iii. *The financial expert must have experience preparing or auditing financial statements that present accounting issues that are generally comparable to those raised by the registrant's financial statements.*

The majority of commenters who thought that the proposed definition of “financial expert” was too restrictive focused on this attribute. We are convinced by the weight of the comments that the proposed requirement that an expert have direct experience preparing or auditing financial statements could impose an undue burden on some companies, especially small companies, that desire to have an audit committee financial expert. We also are persuaded by commenters’ arguments that persons who have experience performing in-depth analysis and evaluation of financial statements should not be precluded from being able to qualify as audit committee financial experts if they possess the other four necessary attributes of an expert. We therefore have broadened this attribute by requiring an audit committee financial expert to have experience “preparing, auditing, analyzing or evaluating” financial statements.<sup>29</sup>

We believe that our revisions properly capture the clear intent of the statute that an audit committee financial expert must have experience actually working directly and closely with financial statements in a way that provides familiarity with the contents of financial statements and the processes behind them. We also believe that our revisions appropriately broaden the group of persons who are eligible to be audit committee financial experts. We recognize that many people actively engaged in industries such as investment banking and venture capital investment have had significant direct and close exposure to, and experience with, financial statements and related processes. Similarly, professional financial analysts closely scrutinize financial statements on a regular basis. Indeed, all of these types of individuals often hold positions that require them to inspect financial statements with a healthy dose of skepticism. They therefore would be well prepared to diligently and zealously question management and the company’s auditor about the company’s financial statements. Effective audit committee members must have both the ability and the determination to ask the right questions. Therefore, we have broadened this attribute to include persons with experience performing extensive financial statement analysis or evaluation.

We also are convinced by commenters that a potential audit committee financial expert should be considered to possess this attribute by virtue of his or her experience actively supervising a person who prepares, audits, analyzes or evaluates financial statements. The term “active supervision” means more than the mere existence of a traditional hierarchical reporting relationship between supervisor and those being supervised. Rather, we mean that a person engaged in active supervision participates in, and contributes to, the process of addressing, albeit at a supervisory level, the same general types of issues regarding preparation, auditing, analysis or evaluation of financial statements as those addressed by the person or persons being supervised. We also mean that the supervisor should have experience that has contributed to the general expertise necessary to prepare, audit, analyze or evaluate financial statements that is at least comparable to the general expertise of those being supervised. A principal executive officer should not be presumed to qualify. A principal executive officer with considerable operations involvement, but little financial or accounting involvement, likely would not be exercising the necessary active supervision. Active participation in, and contribution to, the process, albeit at a supervisory level, of addressing financial and accounting issues that demonstrates a general expertise in the area would be necessary.



Finally, we are retaining, with clarification, the requirement that an audit committee financial expert have experience with financial statements that present accounting issues that are “generally comparable” to those raised by the registrant’s financial statements. We do not intend for this phrase to imply that a person must have previous experience in the same industry as the company that is evaluating the person as a potential audit committee financial expert, or that the person’s experience must have been with a company subject to the Exchange Act reporting requirements. We therefore have modified the requirement to focus on the breadth and level of complexity of the accounting issues with which the person has had experience. We think that a company’s board of directors will make the necessary assessment based on particular facts and circumstances. In making its assessment, the board should focus on a variety of factors such as the size of the company with which the person has experience, the scope of that company’s operations and the complexity of its financial statements and accounting. We do not believe that familiarity with particular financial reporting or accounting issues, or any other narrow area of experience should be dispositive.

- iv. *A financial expert must have experience with internal controls and procedures for financial reporting.*

We are substituting the term “understanding” for the term “experience.”<sup>30</sup> In our view, it is necessary that the audit committee financial expert understand the purpose, and be able to evaluate the effectiveness, of a company’s internal controls and procedures for financial reporting. It is important that the audit committee financial expert understand why the internal controls and procedures for financial reporting exist, how they were developed, and how they operate. Previous experience establishing or evaluating a company’s internal controls and procedures for financial reporting can, of course, contribute to a person’s understanding of these matters, but the attribute as rephrased properly focuses on the understanding rather than the experience.

- v. *A financial expert must have an understanding of audit committee functions.*

We are adopting this attribute as proposed.<sup>31</sup>

Means of obtaining expertise.

We have revised the audit committee financial expert definition to state that a person must have acquired the five necessary attributes through any one or more of the following:

- (1) Education and experience as a principal financial officer, principal accounting officer, controller, public accountant or auditor or experience in one or more positions that involve the performance of similar functions;
- (2) Experience actively supervising a principal financial officer, principal accounting officer, controller, public accountant, auditor or person performing similar functions;
- (3) Experience overseeing or assessing the performance of companies or public accountants with respect to the preparation, auditing or evaluation of financial statements; or
- (4) Other relevant experience.<sup>32</sup>

In response to commenters’ remarks, we have eliminated the proposed requirement that an audit committee financial expert must have gained the relevant experience with a company that, at the time the person held such position, was required to file reports pursuant to Section 13(a) or 15(d) of the Exchange Act. Many private companies are contractually required to prepare audited financial statements that comply

with generally accepted accounting principles. In addition, a potential expert may have gained relevant experience at a foreign company that is publicly traded in its home market but that is not registered under the Exchange Act.

We have added a provision in response to comments that experience overseeing or assessing the performance of companies or public accountants with respect to the preparation, auditing or evaluation of financial statements can provide a person with in-depth knowledge and experience of accounting and financial issues. For example, certain individuals serving in governmental, self-regulatory and private-sector bodies overseeing the banking, insurance and securities industries work on issues related to financial statements on a regular basis. We believe that such experience can constitute a very useful background for an audit committee financial expert.

In addition, we have revised the last provision of this part of the proposed definition. The original proposal stated that a person who had not served in one of the specified positions alternatively could have acquired the relevant attributes and experience in a position that results, in the judgment of the board of directors, in the person's having similar expertise and experience. The final rules state simply that a person may acquire the necessary attributes of an audit committee financial expert through other relevant experience, and no longer require the company to disclose the basis for the board's determination that a person has "similar expertise and experience." We also have eliminated the reference to the judgment of the board with respect to this provision because, as explicitly stated in the audit committee financial expert disclosure requirement, the board must make all determinations as to whether a person qualifies as an expert. Therefore, this reference is redundant.

This revision permitting a person to have "other relevant experience" recognizes that an audit committee financial expert can acquire the requisite attributes of an expert in many different ways. We do believe that this expertise should be the product of experience and not, for example, merely education. Under the final rules, if a person qualifies as an expert by virtue of possessing "other relevant experience," the company's disclosure must briefly list that person's experience.<sup>33</sup>

Proposed factors to be considered in evaluating the education and experience of a financial expert.

The proposed definition of "financial expert" included a non-exclusive list of qualitative factors for a company's board to consider in assessing audit committee financial expert candidates. These factors focused on the breadth and level of a potential audit committee financial expert's experience, understanding and involvement in relevant activities, including the person's length of experience in relevant positions, and the types of duties held by such person in those positions. We believe that the board should consider all the available facts and circumstances, including but certainly not limited to, qualitative factors of the type that we had identified, in its determination. Some commenters were concerned that some boards would use the list as a mechanical checklist rather than as guidance to be used in considering a person's knowledge and experience as a whole. In light of these comments, the definition does not include this list.

The fact that a person previously has served on an audit committee does not, by itself, justify the board of directors in "grandfathering" that person as an audit committee financial expert under the definition. Similarly, the fact that a person has experience as a public accountant or auditor, or a principal financial officer, controller or principal accounting officer or experience in a similar position does not, by itself, justify the board of directors in deeming the person to be an audit committee financial expert. In addition to determining that a person possesses an appropriate degree of knowledge and experience, the board must ensure that it names an audit committee financial expert who embodies the highest standards of personal and professional integrity. In this regard, a board should consider any disciplinary actions to which a



potential expert is, or has been, subject in determining whether that person would be a suitable audit committee financial expert.

Requirement that an audit committee financial expert possess all five required attributes.

We are not convinced by comments stating that an audit committee financial expert should not have to possess all of the attributes included in our definition. Although Congress did not explicitly require us to incorporate all of the attributes listed in Section 407 of the Sarbanes-Oxley Act, it also did not limit us to consideration of those attributes. Congress obviously considered each of the listed attributes to be important. A definition of “audit committee financial expert” that leaves the meaning of the term entirely to the judgment of the board of directors would be highly subjective and could constitute an abrogation of our responsibilities under Section 407.

The Sarbanes-Oxley Act clearly was intended to enhance corporate responsibility by effecting significant change; its purpose was not to perpetuate the status quo. Therefore, while many companies likely will be able to determine that they already have an audit committee financial expert serving on their audit committees, we believe that the fact that some companies will not be able to draw this conclusion unless they are able to attract a new director with the requisite qualifications is consistent with the Act.

Moreover, the Sarbanes-Oxley Act did not contemplate that a company could disclose that it has an audit committee financial expert by virtue of the fact that the audit committee members collectively possess all of the attributes of an expert; the statute directs us to issue rules to require a company to disclose whether or not its audit committee is comprised of “at least one member” who is a financial expert. Due to the statute’s use of this specific language, there is no doubt that Congress had in mind individual experts and did not contemplate a “collective” expert. We note, however, that it would be appropriate under the final rules for a company disclosing that it does not have an audit committee financial expert to explain the aspects of the definition that various members of the committee satisfy.

## **5. Safe Harbor from Liability for Audit Committee Financial Experts**

Several commenters urged us to clarify that the designation or identification of an audit committee financial expert will not increase or decrease his or her duties, obligations or potential liability as an audit committee member. A few recommended a formal safe harbor from liability for audit committee financial experts. Unlike the provisions of the Act that impose substantive requirements,<sup>34</sup> the requirements contemplated by Section 407 are entirely disclosure-based. We find no support in the Sarbanes-Oxley Act or in related legislative history that Congress intended to change the duties, obligations or liability of any audit committee member, including the audit committee financial expert, through this provision.

In the proposing release, we stated that we did not believe that the mere designation of the audit committee financial expert would impose a higher degree of individual responsibility or obligation on that person. Nor did we intend for the designation to decrease the duties and obligations of other audit committee members or the board of directors.

We continue to believe that it would adversely affect the operation of the audit committee and its vital role in our financial reporting and public disclosure system, and systems of corporate governance more generally, if courts were to conclude that the designation and public identification of an audit committee financial expert affected such person’s duties, obligations or liability as an audit committee member or board member. We find that it would be adverse to the interests of investors and to the operation of markets and therefore would not be in the public interest, if the designation and identification affected the duties, obligations or liabilities to which any member of the company’s audit committee or board is subject.

To codify this position, we are including a safe harbor in the new audit committee disclosure item to clarify that:

- A person who is determined to be an audit committee financial expert will not be deemed an “expert” for any purpose, including without limitation for purposes of Section 11 of the Securities Act,<sup>35</sup> as a result of being designated or identified as an audit committee financial expert pursuant to the new disclosure item;
- The designation or identification of a person as an audit committee financial expert pursuant to the new disclosure item does not impose on such person any duties, obligations or liability that are greater than the duties, obligations and liability imposed on such person as a member of the audit committee and board of directors in the absence of such designation or identification; and
- The designation or identification of a person as an audit committee financial expert pursuant to the new disclosure item does not affect the duties, obligations or liability of any other member of the audit committee or board of directors.<sup>36</sup>

This safe harbor clarifies that any information in a registration statement reviewed by the audit committee financial expert is not “expertised” unless such person is acting in the capacity of some other type of traditionally recognized expert. Similarly, because the audit committee financial expert is not an expert for purposes of Section 11,<sup>37</sup> he or she is not subject to a higher level of due diligence with respect to any portion of the registration statement as a result of his or her designation or identification as an audit committee financial expert.

In adopting this safe harbor, we wish to emphasize that all directors bear significant responsibility. State law generally imposes a fiduciary duty upon directors to protect the interests of a company’s shareholders. This duty requires a director to inform himself or herself of relevant facts and to use a “critical eye” in assessing information prior to acting on a matter.<sup>38</sup> Our new rule provides that whether a person is, or is not, an audit committee financial expert does not alter his or her duties, obligations or liabilities. We believe this should be the case under federal and state law.

#### 6. Determination of a Person’s Status as an Audit Committee Financial Expert

The Sarbanes-Oxley Act does not explicitly state who at the company should determine whether a person qualifies as an audit committee financial expert. We believe that the board of directors in its entirety, as the most broad-based body within the company, is best-equipped to make the determination. We think that it is appropriate that any such determination will be subject to relevant state law principles such as the business judgment rule.

#### 7. Location of Audit Committee Financial Expert Disclosure

The Sarbanes-Oxley Act expressly states that companies must include the financial expert disclosure in their periodic reports required pursuant to Section 13(a) or 15(d) of the Exchange Act. The final rules that we are adopting require companies to include the new disclosure in their annual reports on Forms 10-K, 10-KSB, 20-F or 40-F. The requirement to provide the new audit committee disclosure item is included in Part III of Forms 10-K and 10-KSB, enabling a domestic company that voluntarily chooses to include this disclosure in its proxy or information statement to incorporate this information by reference into its Form 10-K or 10-KSB if it files the proxy or information statement with the Commission no later than 120 days after the end of the fiscal year covered by the Form 10-K or 10-KSB.<sup>39</sup>

Although some commenters recommended that we require companies to include the audit committee financial expert disclosure in their proxy and information statements, registration statements and quarterly

reports, as well as in their annual reports, we are not convinced that the benefits to investors would exceed the costs to companies of requiring this disclosure in additional documents or on a more frequent basis.

#### 8. Change in Item Number

We proposed to designate the audit committee financial expert disclosure requirement as new Item 309 of Regulations S-K and S-B.<sup>40</sup> However, existing Item 401 seems to be a more logical location for this requirement. Item 401 currently requires, among other things, a brief description of the business experience of each director. Therefore, we are designating the new disclosure item as Item 401(h) of Regulation S-K and Item 401(e) of Regulation S-B. The new item specifies that a company may choose to include the audit committee financial expert disclosure in its proxy or information statement if the company incorporates such information into its annual report as permitted by the instructions to Forms 10-K and 10-KSB.<sup>41</sup>

#### Footnotes

- 14 See Andrew R. Sorkin, “Back to School, but This One Is for Top Corporate Officials,” NY Times, Sept. 3, 2002, Cassell Bryan-Low, “Defining Moment for SEC: Who is a financial expert,” Wall Street Journal, Dec. 9, 2002, and Geoffrey Colvin, “Sarbanes & Co. Can’t Want This: Under Reform Law, Alan Greenspan Would Not Qualify as a Board’s Financial Expert,” Fortune, Dec. 30, 2002.
- 15 Throughout this release, we will refer to both “audit committee financial experts” and “financial experts” as appropriate in a particular context. For example, when discussing statutory provisions, we will continue to refer to financial experts. For purposes of the discussions in this release, the meanings of these terms are identical.
- 16 See new Item 401(h)(2) of Regulation S-K, Item 401(e)(2) of Regulation S-B, Item 16A(b) of Form 20-F, and paragraph (8)(b) of General Instruction B to Form 40-F.
- 17 The Sarbanes-Oxley Act required only that we adopt rules requiring disclosure of whether a company had at least one financial expert on its audit committee, and if not, the reasons why.
- 18 As we note in our recent release proposing rules to implement Section 301 of the Sarbanes-Oxley Act, there are only 7,250 listed companies out of a total of approximately 17,000 reporting companies. See Release No. 33-8173 (Jan. 8, 2003).
- 19 15 U.S.C. §78j-1(m)(3).
- 20 For example, Section 2(a)(3) of the Investment Company Act of 1940 (15 U.S.C. 80a-2(a)(3)) defines an “affiliated person” as, among other things, any person owning with power to vote five percent of the outstanding voting securities of an entity. Rule 405 (17 CFR 230.405) under the Securities Act defines an “affiliate” as a person that controls or is controlled by, or is under common control with a specified person.
- 21 17 CFR 240.101. That item currently relies on the definitions of “independent” in the listing standards of the New York Stock Exchange, the American Stock Exchange and the NASD. Under Section 10A(m) of the Exchange Act (as amended by Section 301 of the Sarbanes-Oxley Act), we recently proposed rules directing the national securities exchanges and national securities associations to prohibit the listing of any security of an issuer that, among other things, does not have an independent audit committee as that term is used in Section 10A(m)(3). See Release No. 33-8173 (Jan. 8, 2003). As a result of those proposals, the current references in Item 7(d)(3)(iv) of Schedule 14A may be amended. See *id.*
- 22 For domestic issuers, the audit committee independence standard is found in new Regulation S-K Item 401(h)(1)(ii) (17 CFR 229.401(h)(1)(ii)) and Regulation S-B Item 401(e)(1)(ii) (17 CFR

228.401(e)(1)(ii)). See Part II.C, below for further discussion of the audit committee financial expert disclosure requirements for foreign issuers.

- 23 The proposed definition would have broadened the types of persons listed in Section 407 of the Sarbanes-Oxley Act as qualified to serve as experts by enabling the board of directors to conclude that a person is a financial expert if, in lieu of having experience as a public accountant, auditor, principal financial officer, principal accounting officer, or controller, or experience in a position involving the performance of similar functions, the person has experience in a position that results, in the judgment of the board of directors, in the person having similar expertise and experience. Under the proposals, if the board made such a determination, the company would have been required to disclose the basis for that determination.
- 24 The attributes listed in Section 407 of the Sarbanes-Oxley Act include:
- (1) an understanding of generally accepted accounting principles and financial statements;
  - (2) experience in: (a) the preparation or auditing of financial statements of generally comparable issuers; and (b) the application of such principles in connection with the accounting for estimates, accruals, and reserves;
  - (3) experience with internal accounting controls; and
  - (4) an understanding of audit committee functions.
- 25 See new Item 401(h)(2) of Regulation S-K, Item 401(e)(2) of Regulation S-B, Item 16A(b) of Form 20-F and paragraph (8)(b) of General Instruction B to Form 40-F.
- 26 See new Item 401(h)(3) of Regulation S-K, Item 401(e)(3) of Regulation S-B, Item 16A(c) of Form 20-F and paragraph (8)(c) of General Instruction B to Form 40-F.
- 27 See new Instruction 3 to Item 401(h) of Regulation S-K, Item 401(e) of Regulation S-B, Instruction 3 to Item 16A of Form 20-F, and Note 3 to paragraph (8) of General Instruction B to Form 40-F.
- 28 See new Item 401(h)(2)(ii) of Regulation S-K, Item 401(e)(2)(ii) of Regulation S-B, Item 16A(b)(2) of Form 20-F and paragraph (8)(b)(2) of General Instruction B to Form 40-F.
- 29 See new Item 401(h)(2)(iii) of Regulation S-K, Item 401(e)(2)(iii) of Regulation S-B, Item 16A(b)(3) of Form 20-F and paragraph (8)(b)(3) of General Instruction B to Form 40-F.
- 30 See new Item 401(h)(2)(iv) of Regulation S-K, Item 401(e)(2)(iv) of Regulation S-B, Item 16A(b)(4) of Form 20-F and paragraph (8)(b)(4) of General Instruction B to Form 40-F.
- 31 See new Item 401(h)(2)(v) of Regulation S-K, Item 401(e)(2)(v) of Regulation S-B, Item 16A(b)(5) of Form 20-F and paragraph (8)(b)(5) of General Instruction B to Form 40-F.
- 32 See new Item 401(h)(3) of Regulation S-K, Item 401(e)(3) of Regulation S-B, Item 16A(c) of Form 20-F and paragraph (8)(c) of General Instruction B to Form 40-F.
- 33 See new Instruction 2 to Item 401(h) of Regulation S-K, Item 401(e) of Regulation S-B and Item 16A of Form 20-F and Note 2 to paragraph (8) of General Instruction B to Form 40-F.
- 34 For example, the Sarbanes-Oxley Act requires the Commission to direct the self-regulatory organizations by rule to mandate the independence of all audit committee members of companies listed on national securities exchanges and associations. See Section 301 of the Sarbanes-Oxley Act. As another example, Section 402 of the Sarbanes-Oxley Act prohibits certain loans made by companies to their directors and executive officers.
- 35 15 U.S.C. §77k.

- 36 See new Item 401(h)(4) of Regulation S-K, Item 401(e)(4) of Regulation S-B, Item 16A(d) of Form 20-F and paragraph (8)(d) of General Instruction B to Form 40-F. Although other audit committee members may look to the audit committee financial expert as a resource on certain issues that arise, audit committee members should work together to perform the committee's responsibilities. The safe harbor provides that other audit committee members may not abdicate their responsibilities.
- 37 Section 11 of the Securities Act imposes liability for material misstatements and omissions in a registration statement, but provides a defense to liability for those who perform adequate due diligence. The level of due diligence required depends on the position held by a defendant and the type of information at issue. *Escott v. BarChris Construction Corp.*, 283 F. Supp. 643 (S.D.N.Y. 1968). The type of information can be categorized as either "expertised," which means information that is prepared or certified by an expert who is named in the registration statement, or "non-expertised." Similarly, a defendant can be characterized either as an "expert" or a "non-expert."
- 38 See, for example, *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985).
- 39 See General Instruction E(3) to Form 10-KSB [17 CFR 249.310b] and General Instruction G(3) to Form 10-K [17 CFR 249.310].
- 40 We had proposed to add new items to Forms 20-F and 40-F as well. Those item numbers have not changed.
- 41 See new Instruction 1 to Item 401(h) of Regulation S-K and Item 401(e) of Regulation S-B.



## Resources for Audit Committees




**PURPOSE OF THIS TOOL:** Audit committees can take advantage of the Internet and find a wealth of resources to assist them in discharging their responsibilities. This tool provides an overview of organizations and Web sites that contain topical resources for audit committee members to investigate.

Below is a sampling of organizations and Web sites that can assist audit committee members in learning more about their roles, responsibilities, and functions.

### **American Institute of Certified Public Accountants** [www.aicpa.org](http://www.aicpa.org)

The American Institute of Certified Public Accountants (AICPA) is the national professional association for all certified public accountants. This includes CPAs working as independent auditors, accountants, or consultants in public practice, business and industry (CFOs, controllers, internal auditors, etc.), government, not-for-profit organizations, and the academic community.

The AICPA has developed this Audit Committee Toolkit to aid audit committee members in performing their functions. In addition, the AICPA produces publications on accounting and auditing, financial reporting, tax, technology, and many other relevant topics. Some additional online resources useful to audit committees include:

-  Audit Committee Effectiveness Center at [www.aicpa.org/acec](http://www.aicpa.org/acec)
-  Antifraud and Corporate Responsibility Resource Center at [www.aicpa.org/antifraud](http://www.aicpa.org/antifraud)
-  Sarbanes-Oxley Implementation Central at [www.aicpa.org/sarbanes/index.asp](http://www.aicpa.org/sarbanes/index.asp)

### **American Society of Corporate Secretaries** [www.ascs.org](http://www.ascs.org)

The American Society of Corporate Secretaries (ASCS) acts as a positive force for enlightened corporate governance whose key mission is to promote excellence in corporate governance. The members of the ASCS address issues of public disclosure under the securities laws and matters affecting corporate governance, including the structure and meetings of the board of directors and its committees, as well as the proxy process and the annual meeting of shareholders and shareholder relations, particularly with large institutional owners.

### **Association of Certified Fraud Examiners** [www.cfenet.com](http://www.cfenet.com)

The Association of Certified Fraud Examiners (ACFE) is a global professional organization dedicated to fighting fraud and white-collar crime. With chapters around the globe, the ACFE is networked to respond to the needs of antifraud professionals everywhere. They offer guidance on fraud prevention, detection, and investigation, as well as internal controls.



**Business Roundtable** [www.brtable.org](http://www.brtable.org)

The Business Roundtable (BRT) is an association of chief executive officers of leading U.S. corporations. The BRT is committed to advocating public policies that foster vigorous economic growth, a dynamic global economy, and a well-trained and productive U.S. workforce essential for future competitiveness. The BRT's *Corporate Governance Task Force* focuses on issues related to corporate governance and responsibilities, including accounting standards.

**Committee of Sponsoring Organizations of the Treadway Commission** [www.coso.org](http://www.coso.org)

The Committee of Sponsoring Organizations of the Treadway Commission (COSO) is a voluntary private-sector organization dedicated to improving the quality of financial reporting through business ethics, effective internal controls, and corporate governance. Originally formed in 1985 to sponsor the National Commission on Fraudulent Financial Reporting, COSO has released numerous influential publications, including *Internal Control—Integrated Framework*.

**Conference Board** [www.conference-board.com](http://www.conference-board.com)

The Conference Board is a global, independent membership organization that creates and disseminates knowledge about management and the marketplace to help businesses strengthen their performance and better serve society. They conduct research, convene conferences, make forecasts, assess trends, publish information and analysis, and bring executives together to learn from one another. The Conference Board's Blue-Ribbon Commission on Public Trust and Private Enterprise has proposed reforms to strengthen corporate compensation practices and help restore trust in America's corporations and capital markets.

**Corporate Board Member** [www.boardmember.com](http://www.boardmember.com)

*Corporate Board Member* magazine's Web site, Boardmember.com, serves as a central resource for officers and directors of publicly traded corporations, top private companies, and Global 1000 firms. Their Resource Center offers the full-text of *Corporate Board Member* magazine, as well as additional articles, Webcasts, and interviews. Topics include corporate governance, strategic board trends and issues, executive and director compensation, audit committees, risk management, international and technology trends, investor relations, board education, and other critical topics facing today's directors and officers of publicly traded companies. They also offer conferences, director training programs, roundtables, an extensive database, and timely research.

**Ethics Officers Association** [www.eoa.org](http://www.eoa.org)

The Ethics Officers Association (EOA) is the professional association exclusively for managers of ethics, compliance, and business conduct programs. The EOA provides ethics officers with training and a variety of conferences and meetings for exchanging best practices in a frank, candid manner.

**Ethics Resources Center** [www.ethics.org](http://www.ethics.org)

The Ethics Resources Center (ERC) is a nonprofit, nonpartisan educational organization whose vision is a world where individuals and organizations act with integrity. Their mission is to strengthen ethical leadership worldwide by providing leading-edge expertise and services through research, education and partnerships. Especially useful are their resources on business and organizational ethics.

**Financial Executives International** [www.fei.org](http://www.fei.org)

Financial Executives International (FEI) is a professional association for senior level financial executives including chief financial officers, VPs of Finance, Controllers, Treasurers, and Tax Executives. They provide peer networking opportunities, emerging issues alerts, personal and professional development and advocacy services.

**Harvard Business School's Corporate Governance, Leadership & Values** [www.cglv.hbs.edu](http://www.cglv.hbs.edu)

Harvard Business School's Corporate Governance, Leadership & Values Web site is a comprehensive overview of research, educational programs, and other activities at Harvard Business School aimed at providing new frameworks for thought and practice in the interrelated areas of corporate governance, leadership, and values. It includes links to the ongoing workshop series; background papers; research programs, such as the Corporate Governance Initiative; executive education programs; viewpoints on key issues published in the national press; faculty comments in the media; and an online forum for exchanging views on emerging issues.

**Institute of Internal Auditors (IIA)** [www.theiia.org](http://www.theiia.org)

The Institute of Internal Auditors (IIA) is a dynamic international organization that meets the needs of a worldwide body of internal auditors. IIA focuses on issues in internal auditing, governance and internal control, IT audit, education, and security worldwide. The Institute provides internal audit practitioners, executive management, boards of directors and audit committees with standards, guidance, best practices, training, research, and technological guidance for the profession.

**Institute of Management Accountants (IMA)** [www.imanet.org](http://www.imanet.org)

The Institute of Management Accountants (IMA) is a professional organization devoted to management accounting and financial management. Its goals are to help members develop both personally and professionally, by means of education, certification, and association with other business professionals. A respected leader within the global financial community, the IMA influences the concepts and ethical practices in management accounting and financial management. Its ethical standards provide guidance to practitioners for maintaining the highest levels of ethical conduct.

**IT Governance Institute** [www.itgi.org](http://www.itgi.org)

Established by the Information Systems Audit and Control Association and Foundation (ISACA) in 1998, the IT Governance Institute (ITGI) exists to assist enterprise leaders in understanding and guiding the role of IT in their organizations. ITGI helps senior executives to ensure that IT goals align with those of the business, deliver value, and perform efficiently, while IT resources are properly allocated and its risks mitigated. Through original research, symposia and electronic resources, ITGI helps ensure that boards and executive management have the tools and information they need to effectively manage the IT function.

**National Association of Corporate Directors (NACD)** [www.nacdonline.org](http://www.nacdonline.org)

Founded in 1977, the National Association of Corporate Directors (NACD) is the premier educational, publishing and consulting organization in board leadership and the only membership association for boards, directors, director-candidates, and board advisers. The NACD promotes high professional board standards, creates forums for peer interaction, enhances director effectiveness, asserts the policy interests of directors, conducts research, and educates boards and directors concerning traditional and cutting-edge issues.



**New York Stock Exchange** [www.nyse.com](http://www.nyse.com)

The New York Stock Exchange (NYSE) is a not-for-profit corporation that provides a self-regulated marketplace for the trading of financial instruments. Its goal is to add value to the capital-raising and asset-management process by providing the highest-quality and most cost-effective trading environment. They work to promote confidence in and understanding of the financial trading process and serve as a forum for discussion of relevant national and international policy issues. They have taken a leadership role in corporate governance issues through their participation in the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees and more recently in their formation of the NYSE Corporate Responsibility and Listing Standards Committee.

**The Corporate Library** [www.thecorporatelibrary.com](http://www.thecorporatelibrary.com)

The Corporate Library serves as a central repository for research, study, and critical thinking about the nature of the modern global corporation, with a special focus on corporate governance and the relationship between company management, boards, and shareholders. Most general content on the site is open to visitors at no cost; advanced research relating to specific companies and certain other advanced features are restricted to subscribers only.